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Budgeting in Montenegro

by

Dirk-Jan Kraan, Valentina Kostyleva, Barbara Duzler *and* Ragnar Olofsson*

This article examines the budget process in Montenegro. After discussing some general legal, political and economic characteristics of the country, recent institutional reforms are surveyed. The section on the budget formulation process pays special attention to the budget structure and classification, the annual budget preparation cycle, medium-term planning, long-term fiscal sustainability, the organisation of the Ministry of Finance, and the funding of local government. Section 3 addresses the parliamentary approval process, including the role of the budget committee, the annual parliamentary budget cycle, and the impact of Parliament. Section 4 focuses on budget execution, in particular the organisation of the executive process, cash management, and reallocation. Section 5 looks at the supply side of the budget process – public administration and service delivery by the central government as well as by local governments – and at public procurement, public employment, the civil service, and the public enterprise sector. Section 6 examines accounting and audit, including financial reporting, internal audit and external audit.

JEL classification: H610

Keywords: Montenegro, budgeting, budget process, budget formulation, budget execution, parliamentary approval, public service delivery, accounting, audit, financial reporting

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Preface

This review of the budget process of the Republic of Montenegro was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In 2004, the working party established the Network of Senior Budget Officials of Central, Eastern and South-Eastern European countries (CESEE). Budget reviews serve as a basis for the examination of a country's budget institutions by the network in its annual meetings, and enable the participants to discuss the budget procedures of a country in depth.

A team of the OECD Secretariat consisting of Dr. Dirk-Jan Kraan (lead) and Ms. Valentina Kostyleva, supported by Ms. Barbara Duzler (consultant from German International Co-operation) and Mr. Ragnar Olofsson (consultant from the Swedish Ministry of Finance), undertook a mission to Podgorica from 30 May to 1 June 2011 to prepare the review. During the mission, the team met with Mr. Milorad Katnić, Minister of Finance, Mr. Nemanja Pavličić, Deputy Minister of Finance, Ms. Ana Krsmanović, Deputy Minister of Finance, Ms. Biljana Šćekić, Deputy Minister of Finance, Ms. Tijana Stanković, Deputy Minister of Finance, Mr. Dragan Darmanovic, Head of the Debt and Cash Management and International Relations Division of the State Treasury Department, Mr. Mihailo Pejovic, Head of the Accounting Services and Budget Execution Division of the State Treasury Department, Mr. Lav Lajović, Advisor to the Minister for Public Administration Reforms, and other officials of the Ministry of Finance.

The OECD team met also with: Mr. Milan Dabovic, Senator of the State Audit Institution, and other officials of the State Audit Institution; Mr. Zarija Franovic, Vice-President of the Parliamentary Committee of Budget, Economy and Finance; Ms. Katarina Radović, Secretary-General of the Public Procurement Commission; and Ms. Milena Cvijanovic, Financial Director of the Health Insurance Fund, and other officials of the Health Insurance Fund.

The OECD team is grateful to all of these officials for the information they provided and for their willingness to explain the Montenegrin procedures and practices. The OECD team appreciated in particular the openness and frankness with which the interlocutors presented their views on what has been achieved and what still needs to be achieved in the reform of the Montenegrin budget institutions.

The team would like to thank in particular Mr. Vladislav Karadzic of the Budget Operations, Policy and Procedures Division, in the Ministry of Finance, for the excellent organisation of the meetings, his help with the collection of documents, and his practical support during the team's stay in Podgorica.

1. Introduction

1.1. Contents of the review

The main purpose of an OECD budget review is to provide information about the current institutional features of a country's budget process which can serve as a basis of discussion in a meeting of delegates from countries in similar conditions. Such discussions may be useful to other countries in that they can learn from the country under review and may be useful for the country under review because it can receive suggestions from other countries for overcoming problems it is facing (peer review). The OECD Secretariat usually adds its own policy suggestions to the reviews, but in general it strives for restraint in this respect in order to allow maximal room for exchange of views among peers. In the countries of south-eastern and eastern Europe, restraint seems the more appropriate because these countries are already overloaded with policy advice on budget reform from international organisations and foreign donor countries.

The review follows the usual set-up of an OECD budget review. In the remainder of this section, some general legal, political and economic characteristics of Montenegro will be mentioned and recent institutional reforms will be surveyed. Section 2 is devoted to the budget formulation process with separate attention for the budget structure and classification, the annual budget preparation cycle, medium-term planning, long-term fiscal sustainability, the organisation of the Ministry of Finance and the funding of local government. Section 3 addresses the parliamentary approval process with special attention for the budget committee, the annual parliamentary budget cycle, and the impact of Parliament. Section 4 focuses on budget execution with special attention for the annual executive process, cash management, and budgetary discipline. Section 5 looks at the supply side of the budget process: the ministries and agencies that provide for public administration and service delivery at the level of central government, as well as local governments that provide for administration and service delivery at the level of local government. That section also addresses public procurement, public employment and the civil service, and surveys the public enterprise sector. Section 6 looks at accounting and audit, with special attention for financial reporting, internal audit and external audit.

1.2. General characteristics

1.2.1. Legal framework

Montenegro became independent in 2006 after a referendum in which the separation from the federation with Serbia was endorsed by popular vote. The Constitution, established in 2007, provides for a unicameral Parliament (Skupstina) of 81 seats, a directly elected President and an independent judiciary. The Parliament is elected for a four-year period by proportional representation. The President is elected for a five-year period. The government is responsible to Parliament and needs the confidence of Parliament.

The main laws regulating the budget process are:

- Organic Budget Law of 2001.
- Law on the State Audit Institution of 2004.
- Law on Public Internal Financial Control of 2008.
- Law on Local Self-Government Financing of 2003, revised in 2011.

Other relevant laws are:

- Public Procurement Law of 2006.
- Law on Privatisation of Economy of 1996, most recently revised in 2004.
- Law on State Administration of 2003.
- Law on General Administrative Procedure of 2003.

- Law on Local Self-Government of 2003.
- Law on Civil Servants and State Employees of 2010.
- Law on Salaries of Civil Servants and State Employees of 2010.
- Privatisation Law of 1996 (revised several times before and after independence).

1.2.2. Geography and demography

The land area of Montenegro is 13 812 square kilometres, making it one of the smallest countries of former Yugoslavia. The population is roughly 625 000 (2011 census) of which around 187 000 live in the capital, Podgorica. The population includes sizeable ethnic minorities (mostly Serbians, Bosnians and Albanians).

GDP per capita is USD 6 137, somewhat higher than in Bosnia-Herzegovina, Macedonia and Serbia but lower than in Bulgaria, Croatia, Romania and Slovenia.

1.2.3. Gross domestic product[1]

In the 2000s, Montenegro was one of the world's fastest growing non-oil economies. The country pursued a vigorous privatisation and structural reform agenda, introduced a flat income tax at a rate of 9% (one of the lowest in Europe), and made large efforts to create a business-friendly environment. Foreign direct investments, equivalent to 40% of GDP, stimulated domestic demand and economic growth. Commercial banks supported these activities with very large increases in credit (12-month growth rates exceeding 180% in 2007). These increases helped to finance high imports of goods and services (85% of GDP in 2007), leading to a widening of the current account deficit (40% of GDP in 2007). The economic dynamism, exceeding all published projections, resulted in buoyant fiscal revenues and an overall budget surplus in the years 2004-07.

Apart from foreign acquisition of companies, banks, and shares in publicly traded companies, more than one-third of capital inflows in the years before the global financial crisis consisted of elements that were unsustainable, in particular purchases of coastal real estate by British and Russian investors (20% of GDP in 2007) and borrowing from foreign banks (20% of GDP in 2007). Purchases of beach-front property by non-residents represented more than half of total foreign direct investment in 2006 and 2007.

In the third quarter of 2008, banks suffered from a simultaneous run on deposits, loss of access to external financing, and deterioration in asset quality (mostly real estate). Foreign parent banks met liquidity and solvency needs, but the government stepped in to boost liquidity, initially by temporary liquidity injections and subsequently by direct placement of public sector deposits.

At the peak of the boom period, the fiscal stance relaxed through tax cuts and public sector wage increases leading to an increasing structural deficit, estimated by the IMF at 6% of GDP in 2008.

Large industrial enterprises that were sold to smaller investors during the boom years lost access to new financing during the financial crisis, forcing the government to step in by extending guarantees and purchase of equity. Among other things, the government had to retake a significant equity stake in the aluminium plant in exchange for extending loan guarantees. By 2009, public and publicly guaranteed debt had risen to nearly 55% of GDP.

Despite structural reform in many areas, excessively restrictive employment protection and unduly rigid centralised wage-bargaining procedures remained in place.

This contributed to fast wage growth, limited flexibility of the corporate sector, and limited new hiring, thus causing increased unemployment.

The global financial crisis exerted heavy blows upon the economy. The sudden stop in capital inflows dried up the financing of corporations just as the prices of their key export products began to fall sharply. With the very large contractions in industry and construction, the decline in GDP (6% in 2009) would have been even worse but for the ability of the tourism sector to mostly withstand the downturn.

A tentative recovery is now taking hold. Electricity production and industry began to grow again in 2010, but industrial production at end 2010 was still considerably below its peak in 2008. Overall growth in 2008 is estimated at 1.1%, keeping output below its 2008 level.

Table 1 summarises the GDP development of Montenegro since 2007 in comparison to the EU, split into the "old" (pre-2004) member states and the "new" (central and east European) member states.

Table 1. **Growth of real GDP**

Per cent change on previous year

	2007	2008	2009	2010	2011[1]	2012[1]	2013[1]	2014[1]	2015[1]	2016[1]
EU15 (older)	2.8	0.2	–4.3	1.8	1.6	1.9	n.a.	n.a.	n.a.	n.a.
EU10/12 (accession)	5.8	4.3	–3.0	1.8	2.9	3.2	n.a.	n.a.	n.a.	n.a.
Montenegro	10.7	6.9	–5.7	1.1[2]	2.0	3.5	3.7	3.7	3.8	3.8

1. Forecasts.
2. Estimate.
Sources: Eurostat; IMF (2011), "Montenegro: 2011 Article IV Consultation", International Monetary Fund, Washington, DC.

1.2.4. Sectoral structure[2]

Montenegro has a flourishing tourism industry. Tourism is considered to be the backbone of the Montenegrin economic structure. The service sector has experienced large relative growth due to the real estate boom in 2006-07, driven by foreign investment in property along the Montenegrin coast. The banking sector is small but increasingly competitive. Foreign direct investment in the banking sector is large. As a result, Montenegro received more per capita foreign investment than any country in Europe during 2008.

Montenegro's industry sector is dominated by aluminium and steel production and agricultural processing, which account for a majority of Montenegrin exports. The contribution of agriculture to the Montenegrin economic structure is limited. Agricultural production focuses on potatoes, olives, citrus fruits and grapes for both domestic and export markets. Table 2 summarises the sectoral structure of the economy.

Table 2. **Sectoral structure of the economy of Montenegro**

Percentage of total GDP and total domestic employment

	Contribution to GDP (per cent)	Employment (per cent)
Agriculture	10	6.5
Industry	14	20.7
Services (including public administration)	70	72.8

Source: IMF (2011), "Montenegro: 2011 Article IV Consultation", International Monetary Fund, Washington, DC.

1.2.5. Political developments[3]

The Democratic Party of Socialists (DPS) and its leader Mr. Milo Djukanovic had dominated the political landscape in Montenegro since independence. In the 2009 parliamentary elections, the party again gained a convincing victory. The elections were held 18 months ahead of schedule, in March 2009, before the impact of the global financial crisis (which came to Montenegro with some delay) which probably helped the DPS at the ballot box. However, the DPS also did well in the municipal elections of May 2010, supposedly due to the fragmentation of the opposition. The DPS and its allies gained majorities in several cities.

The position of the DPS has been bolstered by the smooth transfer of power from Mr. Djukanovic to his successor, the former finance minister Mr. Igor Luksic, who took over as head of the government in December 2010 just a few days after Montenegro had been granted EU candidate status. Mr. Djukavonic has remained as leader of the DPS, and it is generally assumed that he still has considerable influence over the policies of the DPS.

The current coalition also includes the Social Democratic Party, which in the past has urged a more cautious approach to privatisation and market-oriented reforms.

The main challenge of the current government is the task of promoting economic recovery, following a modest rebound in 2010 from the sharp contraction in 2009. The government also has to deal with some discontent as unemployment remains high. The troubled Podgorica Aluminium Plant, where workers staged strikes and protests against job losses, will remain high on the political agenda.

Divisions among the opposition parties (Movement for Change, Socialist People's Party, Liberal Party, and various ethnically based parties of minority groups) tend to run deeper than those within the governing coalition. The leader of the Movement for Change, Mr. Nebojsa Medojevic, has been a long-standing advocate of a united front. His achievement in 2010 in pursuading other opposition parties to join the Movement for Change in an electoral alliance followed several failed attempts at forging unity. However, Mr. Medojevic's success has not dispelled the sentiment shared by many that the opposition alliance brings together disparate elements, not all of which share the firm commitment of the Movement for Change in the fight against corruption. Since the parliamentary elections of 2009, the Socialist People's Party is the largest parliamentary opposition party. The party split off from the DPS in the late 1990s when it opposed the policy of Mr. Djukanovic to separate Montenegro from Serbia. Currently, the party is again moving closer to the DPS, leading to tensions with the second-largest parliamentary opposition party, New Serb Democracy.

Mr. Luksic's policy is focused on economic recovery. If economic growth gathers momentum in 2011-12, the government hopes that this will pay dividends in the next parliamentary election due in 2013. Mr. Luksic has also declared his intention to step up the fight against corruption, among other things promising constitutional amendments to increase the independence of the judiciary. Combating corruption and organised crime remains a condition for Montenegro's progress with EU integration. In this context, Mr. Luksic has also signalled a more conciliatory approach than his predecessor towards opposition parties and non-governmental organisations, some of which share his commitment in the fight against corruption.

1.2.6. International relations[4]

The government has the overriding goal of advancing EU and NATO integration. EU candidate status, achieved in December 2010, is not expected to translate into an early opening date for EU accession talks which will need to be preceded by further institutional reform, including more resolute action on tackling corruption and organised crime as well as improvement in the public administration. In the case of sufficient progress in these areas, accession talks could be opened in the first half of 2012 at the earliest.

Montenegro hopes to receive an invitation to join NATO in the next few years, having been granted a Membership Action Plan by NATO in December 2009. However, NATO membership remains controversial in Montenegro, in view of its large Serbian minority with bad memories of the NATO bombing campaign during the Kosovo war.

Relations with Serbia are somewhat tense, partly because of differences over Kosovo. Montenegro established diplomatic relations with Kosovo in January 2010. Serbia remains Montenegro's largest trading partner, accounting for 22.7% of Montenegrin exports in 2010. In addition, Serbia is the largest source of Montenegrin imports, with a market share of 26.1% in 2010.

1.3. Foreign aid[5]

Montenegro has been a member of the International Monetary Fund since January 2007. The country has no outstanding purchases or loans from the IMF. Montenegro has received technical assistance from the IMF in various areas, including statistics, financial sector reform, debt management, tax policy and administration, and, in 2011, the development of a medium-term expenditure framework (see Section 2.3.2 below).

Since independence, Montenegro has developed close relations with the EU and has received EU funds. In May 2010, the OECD (SIGMA) produced a report at the request of the EU focusing on democracy and the rule of law, the civil service and administrative law, integrity in government, public expenditure management and control, public procurement, and policy making and co-ordination (OECD, 2010). In February 2011, the Montenegrin government adopted an action plan for meeting EU conditions, requiring ministries to submit regular reports on progress. The European Commission provides expert support for carrying out the plan.

Montenegro joined the World Bank Group (WB) in January 2007 as an independent country. Before then, the WB was already active in the State Union of Serbia and Montenegro, and various projects from that period continued after independence (mainly on solid waste management and health system improvement). Within the framework of the first Country Partnership Strategy for the fiscal years 2007-10, the Board of the WB approved two international development aid credits (USD 19 million) and five loans from the International Bank for Reconstruction and Development (USD 54 million) to provide selective support for three key country priorities: *i)* enhancing sustainable macroeconomic growth; *ii)* building institutions and strengthening the rule of law; and *iii)* improving the standard of living for citizens. Projects in this framework thus far focus on energy efficiency, land administration and agriculture, and institutional development. About 70% of the commitments under these credits and loans remain to be disbursed. In January 2011, the Board approved a second Country Partnership Strategy for the fiscal years 2011-14 (USD 216 million). This programme supports the government's overarching objective of full integration with the EU within a medium-term horizon. The strategy aims at:

i) strengthening institutions and competitiveness in line with EU accession requirements; and *ii)* improving environmental management, including reducing the costs of environmental problems. The centrepiece of the World Bank's engagement will be two financial sector development policy loans (USD 105 million) which will support a programme to strengthen the banking sector, bring regulations into line with EU norms, and encourage the resumption of credit growth.

Montenegro also receives technical assistance from the EU and various EU countries, including a project of German International Co-operation aimed at the improvement of external audit.

1.4. Fiscal and monetary policy[6]

A sharp deterioration in Montenegrin public finances in 2009 pushed the budget into its first significant deficit since independence. After a modest macroeconomic rebound and due to strict budgetary policy, the deficit shrank in 2010. If the economic recovery continues, the budget balance is expected to enter positive territory again in the medium term. Stronger economic growth should lift retail sales which will increase value-added tax, the single largest source of revenue.

The authorities cut the (flat) rate of personal income tax from 12% to 9% in January 2010, but the impact of the cut will be limited because personal income tax makes up a small share of revenue. In addition, the increased social security contributions, introduced at the same time, will more than offset the decline in revenue resulting from the cut in the personal income tax rate.

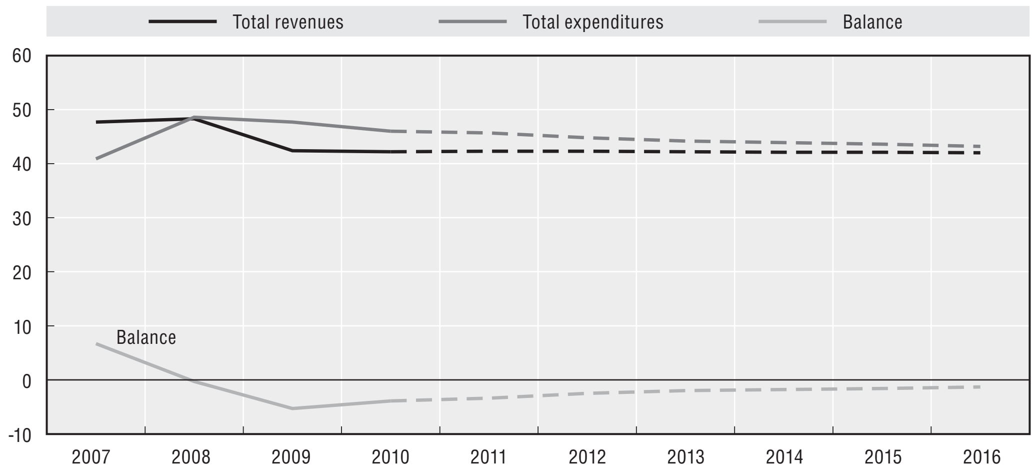
Given that Montenegro is a small open economy and consequently has a small fiscal multiplier, fiscal policy can play only a minor role in macroeconomic steering. In this light, the authorities are rightly committed to consolidation and strict expenditure control. Moreover, credible deficit cuts could well improve investor confidence and thus contribute more to economic growth than fiscal stimulus.

Reflecting mainly significant capital expenditure cuts, the 2010 fiscal deficit is estimated to have declined by 1.5% of GDP to 3.9%. However, loan guarantees of 3.6% were extended to industrial companies. The authorities aim at balancing the budget in 2012 and achieving a sizeable surplus thereafter in order to bolster sustainability, reduce financial risk and boost the economy's resilience to shocks. The authorities also envisage a stricter approach to loan guarantees. The IMF has noted that these goals may be overly ambitious, since they require additional consolidation measures amounting to some 2.5% of GDP in both 2011 and 2012. The IMF sees possibilities, though, to boost revenue collection in a growth-friendly way by a combination of higher rates (personal income tax), better valuation of property, and an improved cadastre (boosting property tax receipts). Regarding expenditures, the IMF and the authorities agreed that the most durable and effective way to consolidate is to cut government employment. The large wage bill constitutes a priority in the authorities' consolidation strategy. In order to avoid excessive reliance on wage cuts, which have adverse effects on morale, the government has introduced the requirement that, for every new hiring, at least two positions need to be cut. The authorities have indicated that they would not hesitate to undertake further measures should the achievement of their targets be at risk (IMF, 2011a).

Figure 1 shows the development of expenditures and revenues and the resulting deficit, including the current forecasts of the government.

Figure 1. **Expenditures, revenues and balance of general government**

Per cent of GDP

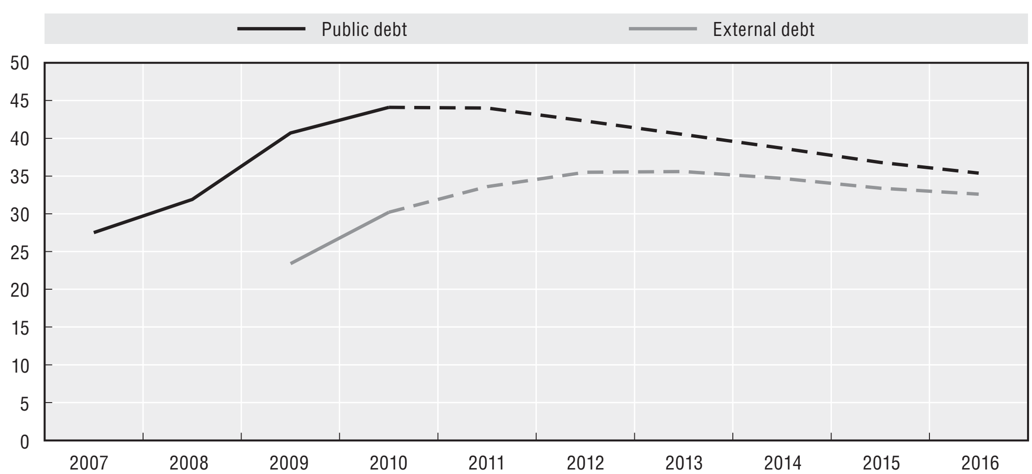


Source: IMF (2011), "Montenegro: 2011 Article IV Consultation", International Monetary Fund, Washington, DC.

Figure 2 shows the development of the public debt for future years in line with the government forecasts of the deficit. Given the limited capacity of domestic capital markets, a substantial part of debt is held by foreign creditors.

Figure 2. **General government public debt**

Per cent of GDP



Source: IMF (2011), "Montenegro: 2011 Article IV Consultation", International Monetary Fund, Washington, DC.

Montenegro has no independent monetary policy in view of the fact that it has unilaterally adopted the euro as currency. Accordingly, the capacity of the Central Bank of Montenegro as a lender of last resort is limited (depending on the size of its own reserves). In addition, Montenegro is dependent on the European Central Bank to hold inflation in check. Thus far this has not caused problems, as inflation has generally stayed below 3%, with a sharp fall in 2010 as a consequence of the crisis (the consumer price index declined in 2010 to 0.5% on an annual basis).

The Central Bank of Montenegro focuses instead on safeguarding financial stability. Key improvements to financial sector legislation were enacted in 2010, including a new central bank law and laws on bankruptcy of banks and on deposit insurance. These efforts benefited from IMF and World Bank advice. The authorities intend to phase out recent temporary relaxations and replace them with permanent regulations in line with international best practice.

1.5. Institutional policy in the recent past

Since independence, Montenegro has been very active in the area of institutional reform of the budget process. A first major reform was the introduction of the treasury consolidated account (single treasury account, STA) in 2002. The account is held at the Central Bank of Montenegro and managed by the State Treasury Department of the Ministry of Finance. Since 2002, more and more spending units are obliged to manage their expenditures and receipts via the STA. The reform is not yet entirely completed, as some spending units are not yet included and some non-tax revenues are still handled via separate bank accounts of spending units.

A second reform led to the integration of the five previously extrabudgetary funds in the areas of social security and health as state funds in the budget. In addition, the expenditures and revenues of the funds are now integrated in the STA. This action was an important step on the way to integration of all government expenditures and revenues in the state budget (required by the budget principles of unity and universality).

A third reform under way is the introduction of public internal financial control (PIFC) and internal audit in accordance with EU standards. The Law on Public Internal Financial Control was adopted in 2008, but implementation is still at an early stage.

In 2011, the Law on Local Self-Government Financing was revised to provide the municipalities with more stable sources of revenue. These sources include a tax-sharing arrangement and an extension of local tax bases.

In 2010, the government adopted a "Decision on the Capital Budget" to replace the current guidelines for the capital budget. The decision aims to rationalise the financing of investment projects by requiring more precise definitions of the projects, conditions on preliminary cost-benefit analysis, and setting of priorities among competing claims of spending units.

As from the 2010 budget, the budget classification was refined so as to apply more systematically the economic classification at the line-item level. This reform does not yet extend to the Health Insurance Fund. Further revision of the classification is envisaged, as some line items are not very informative for budgetary authorities, including Parliament and the State Audit Institution, as to the actual use that is made of the appropriations.

The latest reforms – the Law on Civil Servants and State Employees and the Law on Salaries of Civil Servants and State Employees – were adopted. These laws aimed to bring more uniformity in the rights and obligations and working conditions of civil servants and employees. For that purpose, it is necessary to define types of positions, develop salary scales, define the conditions for variable payments, and regulate the requirements for recruitment and promotion and the procedures for performance assessment. The implementation of these laws is still at an early stage.

Since the 1990s, Montenegro has pursued an active privatisation policy. Currently, only 26 state-owned companies remain, half of which are on the list of companies to be fully or partly privatised according to the Privatisation Plan of 2011. In addition, Montenegro has announced in its "Strategy for Public Administration Reform 2011-16" that it will pursue more systematically the opportunities for outsourcing, requiring annual outsourcing plans from line ministries.

Montenegro has started a reclassification of the budget on a more programmatic basis, thus providing a foundation for more systematic monitoring of policy results. The IMF has urged caution (IMF, 2010, par. 62), arguing that the introduction of a multi-annual framework should have priority over reforms in the sphere of programme budgeting, given the limited capacity of the Ministry of Finance to drive reform in an effective way.

The social security financing gap is one of the largest challenges for fiscal policy in the medium and longer term. The financing gap widened sharply from 1.3% of GDP in 2007 to 5.1% in 2009, to a large extent due to court-mandated pension benefit increases. While increased social security contributions, introduced in connection with the tax reform of January 2010 (see Section 1.4 above), reduced the gap to an estimated 2.6% of GDP, the gap still accounted for nearly 70% of the overall fiscal deficit in that year. The government is aware of the problem and has recently adopted a far-reaching pension reform including three measures: *i)* an increase in the retirement age for men from 65 to 67 and for women from 60 to 67, to be fully implemented in 2025 for men and in 2041 for women; *ii)* re-indexation of pension benefits to 75% of a cost-of-living index and 25% of the general wage level compared to 50-50% previously; and *iii)* a reduction in the frequency of the pension benefit index calculation from biannually to once per year.

Starting with the 2013 budget, the Ministry of Finance intends to introduce a medium-term expenditure framework as a basis for fiscal planning. The ministry has requested technical assistance from the IMF as to the modalities of the framework. As a result, the IMF produced a report on the main principles and set-up of the framework procedure (IMF, 2010) and a second report on the implementation of the framework procedure (IMF, 2011b). The IMF recommends a rolling framework with broad coverage for three years, with two years fixed (not adjustable in the next budget cycle) and one year indicative (adjustable). Currently the Montenegrin government is considering these recommendations.

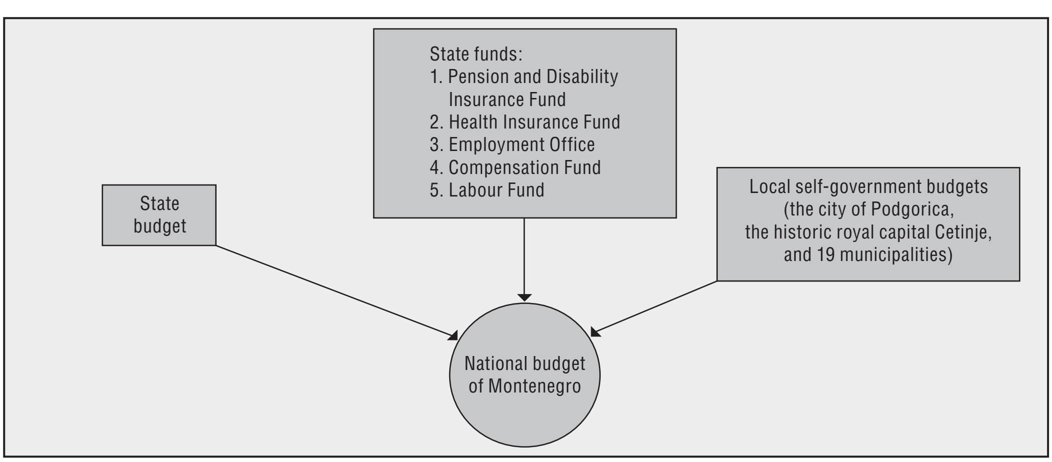
2. Budget formulation

2.1. Structure and classification of the budget

2.1.1. National budget

The national (or consolidated) budget of Montenegro consists of the state budget, the state funds and the local budgets (see Figure 3). There are five state funds: Pension and

Figure 3. **Structure of the national budget of Montenegro**



Disability Insurance Fund, Health Insurance Fund, Employment Office, Compensation Fund, and Labour Fund. In the past, these funds were off-budget. Since 2008, the funds have been integrated into the state budget and have been included in the single treasury account. In the budget classification, they have the same status as spending units.

An overview of the national budget of Montenegro for 2011 by economic classification is provided in Table 3.

Table 3. **National budget of Montenegro for 2011**

	Planned 2011	
	EUR millions	Per cent of GDP
Current revenues	**1 331.90**	**42.01**
Taxes	811.15	25.58
Contributions	359.61	11.34
Duties	30.02	0.95
Fees	82.84	2.61
Other revenues	43.95	1.39
Receipts from repayment of loans	4.34	0.14
Public expenditures	**1 408.64**	**44.43**
Current public expenditures	1 245.90	39.30
Current outflows	736.30	23.22
Gross salaries	*399.75*	*12.61*
Other personal income	*29.52*	*0.93*
Expenditures for supplies and services	*173.97*	*5.49*
Current maintenance	*27.66*	*0.87*
Interest	*48.55*	*1.53*
Rent	*9.03*	*0.28*
Subsidies	*40.37*	*1.27*
Other outflows	*7.45*	*0.24*
Social security transfers	438.95	13.84
Social security related rights	*54.14*	*1.71*
Funds for redundant labour	*19.96*	*0.63*
Pension and disability insurance rights	*343.00*	*10.82*
Other rights related to health care	*14.53*	*0.46*
Other rights related to health-care insurance	*7.32*	*0.23*
Transfers to public institutions, NGOs, etc.	55.23	1.74
Capital budget of Montenegro	162.74	5.13
Loans and credits	**3.81**	**0.12**
Reserves	**11.61**	**0.37**
Surplus/deficit	**–76.74**	**–2.42**
Primary deficit	**–28.19**	**–0.89**
Repayment of debt	**174.44**	**5.50**
Repayment of principal to residents	41.51	1.31
Repayment of principal to non-residents	56.34	1.78
Repayment of arrears	76.59	2.42
Financing needs	**–251.18**	**–7.92**
Financing	**251.18**	**7.92**
Borrowings and credits from domestic sources	5.00	0.16
Borrowings and credits from foreign sources	151.00	4.76
Privatisation revenues	22.00	0.69
Increase/decrease of deposits	73.18	2.31

Source: Ministry of Finance of Montenegro.

2.1.2. Budget classification

The annual budget law is classified by spending units, programmes and economic groups for the purpose of authorisation. A gradual transition to the programme classification has been going on since 2005 with the assistance of the IMF. Since 2008, the programme classification has been fully implemented. In addition, the line items are classified by functional groups (Classification of Functions of Government, COFOG) for informative purposes.

There are 124 spending units in the budget, of which 16 are ministries. Each spending unit has from one to three programmes. In total, there are around 300 programmes. There are no cross-cutting programmes shared by two or more spending units, thus providing for clearly defined ownership of programmes.

Table 4 shows the budget for one of the 124 spending units (the Ministry of Foreign Affairs) in the Budget Law 2010.

As shown in Table 4, the Ministry of Foreign Affairs manages two programmes: diplomacy and administration. There are four main expenditure blocks in its budget, which are also relevant for other spending units: *i)* salaries; *ii)* supplies and services; *iii)* capital expenditures; and *iv)* maintenance. Budgets of other spending units may also contain expenditure for transfers (to individuals, business corporations and the sub-national level). The budget table contains clear, transparent and comprehensive information.

The major concern raised by officials of the Ministry of Finance relates to the lack of breakdown of the line item "contractual services". This line item usually comprises up to 80% of all expenditures for supplies and services. There is no information in the budget on the services acquired under this line item. The Ministry of Finance is currently considering the options for further specification of "contractual services" or for reclassification of "expenditures for supplies and services".

The classification used by Montenegro is mostly in line with the practices of OECD countries. However, one important element is missing in the Montenegrin classification: multi-annual baseline estimates at the line-item level. Although baseline estimates do not constitute appropriations and are not authorised as such, it is important to present them in the same table as the estimates of the budget year. Baseline estimates can even be part of the annual budget law (not only information added to the law for explanatory purposes), implying that they are authorised as official estimates of the costs of current policy in future years.

The authorities may wish to consider reserving a line item in every spending unit's budget for current operational expenditures (salaries and procurement of goods and services), especially if a spending unit operates more than a single programme. The experience of OECD countries shows that the splitting of operational expenditures among different programmes is often a difficult exercise, especially if the capacity of staff is shifted between programmes on a day-to-day basis in the light of temporary needs (for instance, the capacity of the senior staff and the support staff of ministries).

2.1.3. Organisation of the Ministry of Finance

The Ministry of Finance of Montenegro is the central authority for budget preparation, budget execution, cash and debt management, accounting, and financial reporting. The Ministry of Finance comprises eight sectors or departments (see Figure 4) and supervises 12 agencies including the Tax Administration, the Customs Administration, the

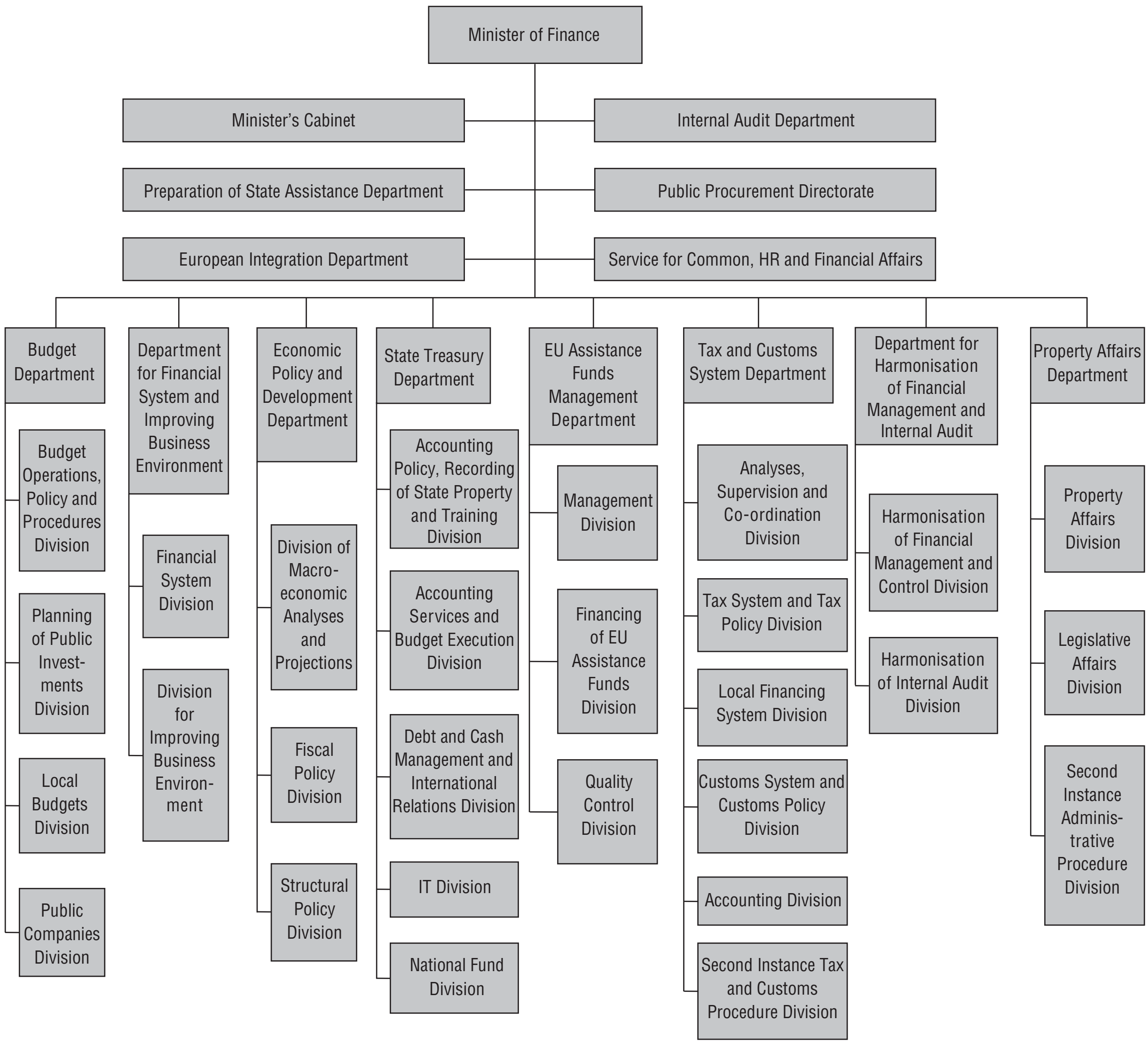
Table 4. **The budget of the Ministry of Foreign Affairs (Budget Law 2010)**

Functional classification	Economic classification		Description	Amount (euros)
	40601		**Ministry of Foreign Affairs**	**3 291 250.22**
	1991		**Programme: Diplomacy**	**3 057 149.30**
	4		**Expenditures**	**3 057 149.30**
	41		**Current expenditures**	**3 036 043.54**
	411		**Gross salaries**	**624 361.22**
113		4111	Net income	375 682.10
113		4112	Income tax	50 464.76
113		4113	Contributions paid by employees	134 572.70
113		4114	Contributions paid by employer	56 071.95
113		4115	Municipal tax	7 569.71
	412		**Other personal income**	**31 850.19**
113		4121	Fee for meals	18 730.22
113		4122	Annual leave allowance	13 119.97
	413		**Expenditures for supplies and services**	**2 361 832.13**
113		4131	Expenditures for supplies	49 710.80
113		4132	Expenditures for business trips	351 597.79
113		4133	Expenditures for national representations	66 000.00
113		4134	Expenditures for energy	14 850.00
113		4135	Expenditures for telephone services	65 231.37
113		4136	Expenditures for postal services	10 040.00
113		4137	Bank charges and exchange rate losses	3 625.36
113		4139	Contractual services	1 800 776.81
	416		**Rent**	**18 000.00**
113		4161	Lease of buildings	18 000.00
	44		**Capital expenditures**	**21 105.76**
	441		**Capital expenditures**	**21 105.76**
113		4415	Expenditures for equipment	21 105.76
	2001		**Programme: Administration**	**234 100.92**
	4		**Expenditures**	**234 100.92**
	41		**Current expenditures**	**224 100.92**
	411		**Gross salaries**	**139 660.06**
113		4111	Net income	81 166.25
113		4112	Income tax	11 842.23
113		4113	Contributions paid by employees	31 493.29
113		4114	Contributions paid by employer	13 386.43
113		4115	Municipal tax	1 771.86
	412		**Other personal income**	**10 385.94**
113		4121	Fee for meals	6 425.94
113		4122	Annual leave allowance	3 960.00
	413		**Expenditures for supplies and services**	**72 054.92**
113		4131	Expenditures for supplies	18 500.00
113		4132	Expenditures for business trips	19 440.00
113		4133	Expenditures for national representations	1 187.83
113		4134	Expenditures for energy	2 970.00
113		4135	Expenditures for telephone services	17 319.69
113		4136	Expenditures for postal services	1 760.00
113		4137	Bank charges and exchange rate losses	600.00
113		4139	Contractual services	10 277.40
	414		**Maintenance**	**2 000.00**
113		4143	Maintenance of equipment	2 000.00
	44		**Capital expenditures**	**10 000.00**
	441		**Capital expenditures**	**10 000.00**
113		4415	Expenditures for equipment	10 000.00

Source: Budget Law 2010, Montenegro.

Administration for Properties, the Administration for Anticorruption, the Administration for the Prevention of Money Laundering, the Public Procurement Directorate and the State Bureau of Statistics. The total staff of the Ministry of Finance amounts to 173 civil servants and employees (as of May 2011).

Figure 4. **The organisational structure of the Ministry of Finance**



2.2. The annual budget cycle

2.2.1. Budget calendar

The budget in Montenegro is adopted for one fiscal year which coincides with the calendar year. The phasing of budget preparation is broadly prescribed in the Organic Budget Law (OBL). The Ministry of Finance decides further on the procedures not prescribed by the OBL. Table 5 shows the current budget calendar.

Table 5. **The current budget calendar**

April	The government adopts the Fiscal Policy Statement.
May	The Ministry of Finance issues the budget circular for spending units, fixing expenditure targets.
Late July	Spending units submit their requests to the Ministry of Finance for the upcoming budget year.
September	The Ministry of Finance holds negotiations with spending units. Macroeconomic projections for the forthcoming budget year are updated.
Late October	The Ministry of Finance submits the budget bill to the government.
November	The budget bill is submitted to Parliament.
December	The budget law for the upcoming year is adopted.

2.2.2. Fiscal Policy Statement

The budget cycle starts with the adoption by the government of a report on macroeconomic and fiscal policy for the upcoming budget year. Together with an analysis of the execution of the current budget, the report (also called the Fiscal Policy Statement) outlines targets of fiscal policy and provides estimates of revenues and expenditures for a four-year term (t + 1, t + 2, t + 3 and t + 4) for the whole of general government. The statement provides macroeconomic projections which underlie the budget preparation process. As from 2011, the adopted guidelines are sent to Parliament for information.

2.2.3. Budget circular

In May, the Ministry of Finance issues the budget circular (called "technical instructions" in the OBL) for the preparation of budgets of spending units and municipalities for the upcoming fiscal year. The circular contains "important economic parameters, instructions, guidelines and deadlines for preparation of the budget, approximate amounts of expenditures for each spending unit and recommendations for the approximate amounts of expenditures of local self-governments, based on which the spending unit and local self-government unit shall independently plan their expenditures, as well as capital budget projection for the following year, with the assessment of expenditures of current and capital budget for the following three years, based on the guidelines and objectives of fiscal policy established by the government" (Article 20 of the OBL).

The major weakness of the Montenegrin budget circular is that it lacks budget ceilings.[7] This "bottom-up" approach to budget preparation leads to inflated budget requests from line ministries. As a consequence, the Ministry of Finance has to negotiate each line item with the spending units. This practice contrasts with a "top-down" approach practised by many OECD countries. The top-down approach allows a finance ministry to focus on major allocational decisions, and provides line ministries and agencies with the autonomy to decide on the details within the fixed limit. Another problem in Montenegro consists in the lack of control of local government finances (see Box 1).

2.2.4. Budget requests of spending units and negotiations

Spending units submit their budget requests to the Ministry of Finance by the end of July. The requests contain the following (according to Article 21 of the OBL):

- current-policy budget estimates;
- transactions of financing estimates (transfers);
- capital budget estimates;

Box 1. **Municipal finances**

There are 21 municipalities in Montenegro, of which the city of Podgorica has the status of administrative capital city and the municipality of Cetinje that of historical or "royal" capital. The Law on Local Self-Government, the Organic Budget Law and the Law on Local Self-Government Financing regulate the organisation and financial matters within municipalities as well as their financial relationship with the central government.

In 2011, the expenditure of municipalities constitutes EUR 156 million or 4.9% of GDP. The state budget expenditure is EUR 1 254 million or 39.5% of GDP. According to the Law on Local Self-Government Financing (LLSGF), the municipalities are financed from different sources:

- Local taxes, most importantly a property tax and a surtax on personal income tax. The municipalities can set the tax rates within limits set by the central government. In 2011, the local taxes will constitute around 25% of total revenues.
- Tax sharing of revenues collected within the territory of the municipality: 12% of income tax of natural persons, 80% of real estate transfer tax. The tax-sharing arrangements account for 25% of total revenues.
- Fees and duties, including shared fees with the central government for concessions and motor vehicles, make up around 40% of revenues.
- Loans and credits.
- Revenues from privatisation and sale of property.

There is also an Equalisation Fund. Its revenues come from the income tax and the real estate transfer tax. The grants from the Equalisation Fund have been based on revenue per capita, but the distribution formula has been improved by looking at fiscal capacity (theoretical rather than actual revenues) as well as budgetary needs (instead of collected revenues, as in the past). The new distribution formula will be fully implemented as from 2012. From 14 to 15 municipalities receive net contributions from the Equalisation Fund.

Direct transfers or grants from the central government budget to municipalities make a very small percentage in total revenues of municipalities (less than 1%), and are mostly intended for co-financing of European funds for projects aimed at municipal infrastructure development.

Even though the independence of the municipalities is guaranteed by the Constitution, there are also means for the central government to exercise control over the municipalities when they are not complying with the rules. After 90 days of non-compliance, the central government can issue a warning and, if the issue is not solved within six months after the warning, the central government may dissolve the municipal assembly and discharge the mayor from duty.

The central government's main instrument for controlling the finances of the municipalities is the restriction on borrowing. According to the LLSGF, the total principal and interest repayment related to municipal debt in a current fiscal year may not exceed 10% of the current revenues of the municipality in the previous fiscal year. However, even when a municipality meets this condition, the Ministry of Finance is entitled to reject the request of the municipality for borrowing, taking into account the macroeconomic situation in the country. Guarantees provided by municipalities need approval by the Ministry of Finance. Furthermore, the municipalities are obliged to provide the Ministry of Finance with information on their budget and final accounts. In addition, municipalities have to provide the ministry with quarterly reports on budget execution.

During the boom years, many municipalities entered into large investment projects which were financed – at least partly – by current revenues. With the worsening fiscal situation and revenue loss, this state of affairs has created fiscal problems resulting in arrears which are quite substantial. In the 2011 budget, the repayment of arrears of the 21 municipalities amounts to EUR 21 million, a substantial share of total central government expenditures of EUR 156 million. The municipalities have to submit quarterly data, but the quality of the reports is not satisfactory according to officials of the Ministry of Finance, and the complete picture of commitment and arrears is not clear until the final reporting at the end of the budget year.

- line-item estimates for the upcoming budget year according to economic, functional, programme and project classification, determined by the Ministry of Finance in accordance with international standards;
- funding sources (including non-tax revenues);
- explanation of expenditure estimates.

The budget requests largely exceed the indicative amounts of expenditure mentioned in the budget circular. Therefore, emphasis is placed at this stage on bilateral negotiations between the Ministry of Finance and individual line ministries regarding detailed spending items, in an attempt to whittle down the requests of spending units. Meetings with separate line ministries are held in September. Line ministries, accompanied by their subordinated spending units, take the opportunity to justify the need for additional spending. Regardless of these often contentious negotiations, the final budgets of spending units agreed by the Ministry of Finance may only be slightly increased compared to the indicative targets of the budget circular.

2.2.5. Macroeconomic forecasts

The macroeconomic forecasts underlying the revenue side of the budget bill are produced by the Ministry of Finance. The department of the ministry responsible for macroeconomic projections has recently been reorganised. Until 2010, a unit in the Budget Department in the Ministry of Finance (Macroeconomic Analyses Division) was in charge of producing revenue forecasts. Starting from 2011, a new Economic Policy and Development Department of the Ministry of Finance (with a staff of 20) took over this task. Its remit is to provide government-wide macroeconomic projections. In line with EU recommendations, this reorganisation aimed at broadening and strengthening the forecast function for the government as a whole and making the forecasting unit more independent.

The revenue projections are produced on a monthly and a quarterly basis. During the budget cycle, there are two major releases of macroeconomic assumptions: in a report in April which is used for the Fiscal Policy Statement, and in a report in September which feeds into the budget bill. In the production of its reports, the Economic Policy and Development Department co-operates with the Central Bank of Montenegro, the Statistical Office of Montenegro and the Institute for Strategic Studies and Projections.

The Economic Policy and Development Department does not provide expenditure projections ("baseline estimates"), and it is not envisaged that it will do so in the future. The department is also not expected to provide costing estimates for new spending plans of the government or of political parties.

2.2.6. Submission of the annual budget law

At the next stage of the budget cycle, the Ministry of Finance drafts the budget bill and submits it to the Cabinet by the end of October. The government sends the budget bill to Parliament in November to be adopted in December.

2.3. Modernisation of public finance management

2.3.1. Multi-annual planning and top-down budgeting

The major weakness of the Montenegrin budgeting procedure is the focus on the upcoming budget year and the absence of multi-annual financial planning. Sectoral plans do not elaborate medium-term costs and their distribution over time. The four-year estimates in the Fiscal Policy Statement have few links with the annual budget preparation process and with sectoral plans.[8]

The other problem, discussed in Section 2.2.3 above, concerns the "bottom-up" approach used in budget preparation. The absence of binding ceilings for spending units at the initial stage of budget preparation leads to creep in the numbers during the negotiation process or to frustration on the part of line ministries as their demands are not met. Moreover, it shifts the focus of the Ministry of Finance from important strategic decisions to negotiating and streamlining the budget requests of line ministries.

The authorities are aware of the benefits that multi-year financial planning and "top-down" budgeting may bring. At present the Ministry of Finance, assisted by the IMF, is considering options and preparing a legislative package aimed at introducing a medium-term expenditure framework (IMF, 2010, 2011b).

2.3.2. Medium-term expenditure framework

Medium-term expenditure frameworks (MTEFs) play an important role in OECD countries. The level of commitment with regard to MTEFs in these countries is generally high, which promotes fiscal discipline and improves budgetary outcomes (a surplus or a low deficit, and low debts). As of 2008, 20 OECD countries[9] have been working with expenditure frameworks establishing ceilings or targets for periods covering from three to five years (see Box 2).

Montenegro is considering introducing a rolling MTEF. The current plan would imply the establishment of aggregate ceilings over the medium term (two years fixed plus one year indicative), the reservation of the margins between the ceiling and the sum of the baseline estimates to create room for unforeseen events and possible new spending initiatives, and the introduction of binding resource envelopes for spending units for the upcoming budget year (fixing the totals for line ministries and other direct spending units at the beginning of the annual budget preparation). This model is inspired by the Swedish experience. It stands in contrast to the Anglo-Dutch model in which the margins between the ceiling and the sum of the baseline estimates (if any) are filled with new spending for all out-years of the framework (years after the upcoming budget year) at the moment when the framework is decided. The latter model implies that the spending envelopes for spending units are basically fixed for all years of the framework, even if formally reallocation between the envelopes is allowed from year to year (experience shows that such reallocation is in practice difficult and rare, because it supposes that spending units give up resources that they counted upon).

The Ministry of Finance intends to exempt interest payments, pension benefits and expenditure financed by EU funds from the ceilings.

Under the current plan, the margin between the ceiling and the sum of the baseline estimates resulting from the decisions of the previous year would be available during budget preparation for new spending. The Ministry of Finance is also considering refraining from distributing the margin in any year if revenue setbacks drive up the deficit beyond an acceptable level. The decision on allocation of the margin is not taken by the Ministry of Finance through negotiations, but by the Cabinet on the basis of requests elaborated by spending units. This process means that spending units would be required to make a strict split between requests concerning the costs of current policies and

Box 2. **Medium-term expenditure frameworks in OECD countries**

An expenditure framework is a normative instrument capturing policy objectives of the government and imposing limits on spending over the medium term. The design of expenditure frameworks differs across countries. The frameworks can be either flexible (annually updated each year in light of the previous year's outcomes, new estimates of the consequences of current policies and new political priorities) or fixed (when the figures remain unaltered from year to year once they have been set).

The major advantage of a flexible framework in comparison to no framework is that, at the time of budget formulation, the multi-annual consequences of all policy changes have to be traded off against each other and against the adjustment of medium-term targets. This guarantees that the consequences of new spending initiatives in future years (which may be larger than in the first year, so-called "camel noses") are accounted for. Similarly, it allows for due consideration of savings measures which phase in slowly – which is the case with most major measures since they require changes to the law or reorganisation of administrative units.

A few countries (notably Austria, the Netherlands, Sweden and the United Kingdom) have fixed expenditure frameworks. The major advantage of a fixed expenditure framework over a flexible framework is that it is (more) effective in realising multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realised as long as the framework is maintained. In addition, a fixed framework contributes to automatic stabilisation because autonomous fluctuations in tax revenues are not allowed to affect the expenditure level. Although only a few OECD countries work with a fixed expenditure framework, many others seek to keep their expenditure framework as stable as possible from year to year (without formally committing to a fixed framework).

An expenditure framework can be rolling like in Austria and Sweden, or it can be periodical like in France and the United Kingdom. In a rolling framework, an additional year is added at the end of the framework period when the first year (or budget year) expires. In a periodical framework, a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new cabinet period.

Expenditure frameworks can be distinguished along several other dimensions, notably the number of future budget years covered, the number of ceilings they establish, and their comprehensiveness (the share of expenditures subject to the ceiling). In terms of future budget years covered, many frameworks cover a three-year period (France, Sweden) or a four-year period (Finland, the Netherlands). In 2010, the United Kingdom moved from a three-year to a five-year forward framework. In terms of the number of sub-ceilings, some frameworks establish only a single aggregate ceiling on expenditures (Sweden), while others contain a number of binding sub-ceilings at the ministerial level (Netherlands, United Kingdom) or at the policy area level (France). In terms of comprehensiveness, some governments have exempted particularly volatile items or items determined by entitlements from the ceilings (for instance, the United Kingdom has exempted interest payments and social security expenditure).

requests for new spending. This split is partly already foreseen in Article 21 of the OBL (see Section 2.2.4 above), but the formulation of the OBL is not very clear on this point and, in practice, the distinction between the costs of current policy and new spending initiatives is often blurred in the request documents.

The mentioned policy intentions give rise to a number of comments:

- Fixing ceilings for two years is a rather ambitious policy objective. Only a few OECD countries work with fixed expenditure frameworks. Strict fiscal discipline, good quality of revenue and expenditure forecasts and, most importantly, political commitment are necessary requirements. A fixed framework implies the engagement of the government to maintain the totals regardless of factors such as revenue volatility, errors in estimates or change of political priorities. Failure to maintain the ceilings once they have been announced as fixed would undermine the credibility of the reform. A more cautious approach would be to maintain the ceilings at least during budget preparation and execution through strict budgetary discipline, but to allow the framework to be adjusted from year to year. The government can then still announce its intention to keep ceilings as stable as possible from year to year, but without loss of credibility if it makes adjustments after all.
- In view of the intention of the Ministry of Finance to refrain from distributing the margin between the ceiling and the sum of the baseline estimates in case of tax revenue shortfalls, an adjustable ceiling comes close to the current plan. Indeed, saving the budget margin comes down to a temporary adjustment of the ceiling. However, it is recognised that the possibility of saving the margin works only in one direction – namely that of downward adjustment of expenditures in case of revenue shortfalls – and is thus "safer" from the point of view of budgetary discipline than a flexible (adjustable) framework that can also lead to upward adjustment of expenditures.
- The fact that a fixed ceiling contributes to automatic stabilisation is not very strong in the case of Montenegro, given its small open economy that can be affected only to a very modest extent by government spending. Moreover, the fact that the ceilings would remain fixed only for two years diminishes the strength of this argument, since economic fluctuations have a longer cycle than two years. On the other hand, the argument that a fixed ceiling brings tranquillity to the expenditure side of the budget and allows line ministries to plan in the medium term does apply to Montenegro.[10]
- Regardless whether the government finally opts for adjustable ceilings or for fixed ceilings with the possibility of saving the margin, adjustment of the expenditure level should only be considered in the case of revenue shortfalls that can be seen as structural and not merely cyclical. In fact, one of the main aims of an expenditure framework is to isolate expenditure policy from cyclical fluctuations in tax revenues and thus keep the path of expenditure development as stable as possible. This aim is jeopardised if fluctuations on the revenue side are allowed to impact upon expenditures. In order to identify structural tax revenue changes, it is advisable to define them *a priori*, for instance by specifying a band of fluctuation around the revenue trend that will be considered as cyclical and that needs to be exceeded for a setback to be recognised as structural. If structural changes are not defined *a priori*, the identification of setbacks as structural may become a subject of political debate.
- The exemption of pension benefits is not consistent with the logic of an expenditure framework. It is true that these expenditures are determined by entitlement legislation (mandatory expenditures), but the very aim of an expenditure framework is that fiscal policy is planned in advance so that the adjustment of laws and organisations can be set in motion in a timely manner.

The introduction of the medium-term expenditure framework as envisaged by the Ministry of Finance would require changes in the budget calendar. Table 6 summarises the required changes.

Table 6. **The revised budget calendar, as envisaged**

April	● Update of the medium-term expenditure framework (binding ceilings for t + 1 and t + 2, and an indicative ceiling for t + 3). ● The Ministry of Finance prepares a proposal for the use of the budget margin for t + 1 and updates the envelopes for t + 2 and t + 3. The Ministry of Finance also proposes the allocation of expenditure between spending units.
May	● The government approves spending unit ceilings for t + 1, aggregate expenditure ceilings for t + 2, and aggregate indicative expenditure ceilings for t + 3. ● The Ministry of Finance issues the budget circular for spending units with fixed expenditure ceilings.
Mid-July/August	● Spending units submit their requests to the Ministry of Finance for t + 1, and expenditure projections for t + 2 and t + 3 by main economic category. ● The Ministry of Finance holds negotiations with spending units.
September	● Medium-term macroeconomic projections are updated.
Late October	● The Ministry of Finance submits the budget bill to the government.
November	● The budget bill is submitted to Parliament.
December	● The budget law is adopted.

2.3.3. Baseline estimates

In order to be credible and realistic, an expenditure framework should be built on multi-annual estimates on the basis of current policy or current law ("baseline estimates").

Box 3. **Baseline estimates in OECD countries**

OECD countries that work with expenditure frameworks produce and update multi-annual baseline estimates. Each programme has its own particular set of factors that will affect expenditures – for instance economic variables, demographic developments, price changes or participation rates. The baseline estimates capture the cost of current law and/or current policy over the medium term and are essential to ensure the consistency of current law or policy with the multi-annual ceilings. Best practice in OECD countries shows that baseline estimates are frequently updated to reflect any changes in the underlying variables (usually monthly or quarterly) and are prepared at a line-item level (the same level of detail as the annual budget). They should be part of the annual budget proposal submitted to parliament (OECD, 2002). The baseline estimates should also be agreed between the line ministry and the finance ministry. The baseline estimates are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution. During execution, they alert at an early stage to overspending, which should immediately trigger corrective measures (not in the next budget).

Establishing the expenditure framework can be seen as a top-down process, and preparing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line-item estimates is central to a disciplined budget process.

Baseline estimates in Montenegro are prepared by spending units. The forecasting division of the Ministry of Finance (the Economic Policy and Development Department) does not produce expenditure projections. In the absence of independent forecasts, the spending units are inclined to provide inflated baseline estimates in attempts to increase the ceilings of the MTEF when the ceilings for future out-years are decided or to acquire room under the ceilings at the expense of the budget margin for the years the ceilings are fixed. Careful preparation of baseline estimates is therefore a crucial condition for the successful implementation of an MTEF. Smaller line items should be checked by the expenditure division (the Budget Department) of the Ministry of Finance, and large line items – in particular those that are dependent on demographical developments, such as education and health, or that are determined by entitlement legislation, such as social security – should be checked by an independent forecasting institution. The latter task could be taken up by the new Economic Policy and Development Department.

Reliable baseline estimates are not only important for the periodical extension of the framework (annual in the case of a rolling MTEF), but also for the maintenance of budgetary discipline. Ceilings can only be maintained during budget preparation and execution if overspending on any line item is discovered as soon as it occurs and immediately corrected, either by savings measures on the line item or by compensation on other line items. It is true that, in view of the strict preventive control procedures in Montenegro, overspending during the budget year cannot easily occur, but this is not the case for the out-years. Budgetary discipline requires that overspending in out-years is equally corrected or compensated. This is only possible if the baseline estimates for the out-year are frequently updated (at least quarterly) and if strict rules of budgetary discipline are in place that require savings or compensation through concrete policy measures. The Budget Department of the Ministry of Finance has an important role in the supervision of compliance with these rules.

2.3.4. Fiscal rules

Well-designed fiscal rules supported by political commitment are the most efficient instrument to promote fiscal sustainability. In the past three years, fiscal rules were particularly at the centre of academic and political discussions as the financial crisis exposed the vulnerability of discretionary policies. At present, many OECD countries are reconsidering their fiscal arrangements and announcing their adherence to new fiscal rules which would be conducive to achieving their debt and deficit targets in the medium and long term.

According to the definition of a fiscal rule proposed by Kopits and Symansky (1998, p. 2), a fiscal rule is "a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance (…). A critical feature of a fiscal rule is that it is intended for application on a permanent basis by successive governments in a given country." Fiscal rules can serve different goals, and their role in promoting budgetary control varies. Fiscal rules can be applied to various fiscal aggregates, such as measures of expenditure, revenue, budget balance or debt.

The introduction of an expenditure rule or an expenditure framework anchored in a structural balance rule is a common tendency in many OECD countries. Expenditure rules may take the form of permanent limits on total, primary or current spending in absolute terms, in growth rates, or in per cent of GDP.[11] An expenditure framework puts ceilings on expenditure in nominal or real terms.

A structural balance rule puts a constraint on the budget balance over the economic cycle in order to guarantee debt sustainability in the long term. This may require gradual debt reduction if public debt is currently unsustainable (with interest payments growing at a higher rate than GDP), or it may require temporary debt reduction in the coming decades to allow for some growth of public debt during a foreseeable period of demographic imbalance (in the case of an ageing population).

Sweden uses a structural surplus rule, requiring that the budget is at least 1% in surplus over the economic cycle. Even though the financial crisis has pushed some countries off this path in the last few years (for instance, the Netherlands aimed at a structural surplus in the past and its current target is to restore balance by 2015), a surplus rule remains necessary to achieve long-term sustainability for countries with high debts and ageing populations.

If the Montenegrin authorities proceed with the introduction of a fixed or flexible MTEF, they will have to make a decision regarding the structural balance rule on which the MTEF is to be based. Montenegro has no ageing problem. However, in view of its small open economy with relatively high vulnerability to fluctuations in international capital markets, Montenegro cannot afford a public debt in the order of the Maastricht criterion of 60% of GDP. In order to maintain the confidence of international capital markets, the debt target should be much lower. The exact figure can be determined in a fiscal debt rule. In order to achieve the low debt target, it would be necessary to steer successive MTEFs on the basis of a structural surplus[12] target. The Montenegrin authorities can decide on the percentage of surplus over the cycle, depending on the speed at which they want to attain the sustainable debt target and on the GDP growth.

Another type of fiscal rule which is relevant for Montenegro relates to revenue. Since the MTEF does not relate to revenue, some constraint on revenue is necessary to make sure that the structural balance rule is not undermined by tax relief or tax expenditures. A revenue rule that serves this purpose is the "pay-as-you-go" rule (the colloquial name for the revenue provisions of the now expired Budget Enforcement Act of the United States). This rule, which is used in various countries that have MTEFs in place for the expenditure side of the budget, requires that any enacted tax change (as opposed to autonomous changes in the tax yield in response to GDP developments) should be fully compensated by enacted tax changes in the opposite direction. For instance, the introduction of or rate increase in a tax expenditure should be compensated by a rate decrease in another tax expenditure or by a rate or base increase in a general tax. The pay-as-you-go rule is straightforward and simple to understand, and arguably constitutes the easiest way to achieve budgetary discipline on the revenue side of the budget.

2.4. Conclusion

The budget classification in Montenegro is programme based, which allows the government and Parliament to assess budget proposals in terms of their contribution to the realisation of policy objectives. The annual budget law provides information on the allocation of resources in a transparent and comprehensive manner. It is a coherent and easily readable document. The proposal to break down the line item "contractual services", as envisaged by the Ministry of Finance, is commendable but should not lead to a large increase of the number of line items.

The establishment of a separate Economic Policy and Development Department in the Ministry of Finance, tasked with macroeconomic forecasting, is a commendable development. The government may wish to consider extending the tasks of the department to include expenditure forecasts of major programmes and, possibly, the costing of new policy initiatives. Independent forecasts would provide an objective basis for setting up aggregate ceilings and sectoral envelopes for the MTEF.

The introduction of an MTEF as part of the budget process is a timely and sensible initiative. It will contribute to medium-term fiscal planning and fiscal discipline. The introduction of the MTEF would reverse the "bottom-up" approach to a "top-down" approach. The spending units would be restrained in their budget requests from the start of budget preparation and would not be able to renegotiate the totals through the bilateral discussion of detailed spending items with the Ministry of Finance.

The production of reliable baseline estimates is a crucial condition for the successful implementation of an MTEF. Baseline estimates should be regularly updated (at least quarterly) and carefully checked by the Budget Department of the Ministry of Finance. Baseline estimates for major programmes could be established, or at least checked, by the Economic Policy and Development Department.

Fixing ceilings for two years is a rather ambitious policy objective. Only a few OECD countries work with fixed expenditure frameworks. Strict fiscal discipline, good quality of revenue and expenditure forecasts and, most importantly, political commitment are necessary requirements. A fixed framework implies the engagement of the government to maintain the totals regardless of factors such as revenue volatility, errors in estimates or change of political priorities. Failure to maintain the ceilings once they have been announced as fixed would undermine the credibility of the reform. A more cautious approach would be to maintain the ceilings at least during budget preparation and execution through strict budgetary discipline, but to allow the framework to be adjusted from year to year. The government can then still announce its intention to keep ceilings as stable as possible from year to year, but without loss of credibility if it makes adjustments after all.

The fact that a fixed ceiling contributes to automatic stabilisation is not very strong in the case of Montenegro, given its small open economy that can be affected only to a very modest extent by government spending. Moreover, the fact that the ceilings would remain fixed only for two years diminishes the strength of this argument, since economic fluctuations have a longer cycle than two years. On the other hand, the argument that a fixed ceiling brings tranquillity to the expenditure side of the budget and allows line ministries to plan in the medium term does apply to Montenegro.

Regardless whether the government finally opts for adjustable ceilings or for fixed ceilings with the possibility of saving the margin, adjustment of the expenditure level should only be considered in the case of revenue shortfalls that can be seen as structural and not merely cyclical. In fact, one of the main aims of an expenditure framework is to isolate expenditure policy from cyclical fluctuations in tax revenues and thus keep the path of expenditure development as stable as possible. This aim is jeopardised if fluctuations on the revenue side are allowed to impact upon expenditures. In order to identify structural tax revenue changes, it is advisable to define them *a priori*, for instance by specifying a band of fluctuation around the revenue trend that will be considered as cyclical and that needs to be exceeded for a setback to be recognised as structural. If structural changes are not defined *a priori*, the identification of setbacks as structural may become a subject of political debate.

The exemption of pension benefits is not consistent with the logic of an expenditure framework. It is true that these expenditures are determined by entitlement legislation (mandatory expenditures), but the very aim of an expenditure framework is that fiscal policy is planned in advance so that the adjustment of laws and organisations can be set in motion in a timely manner.

If the Montenegrin authorities proceed with the introduction of a fixed or flexible MTEF, they will have to make a decision regarding the structural balance rule on which the MTEF is to be based. In view of its small open economy with relatively high vulnerability to fluctuations in international capital markets, Montenegro cannot afford a public debt in the order of the Maastricht criterion of 60% of GDP. In order to guarantee its access to capital markets, also in times of economic downturn, Montenegro should aim at a much lower long-term public debt level (the Montenegrin authorities can decide on the exact percentage and express it as a fiscal debt rule). In order to achieve this low debt objective, it would be necessary to steer successive MTEFs on the basis of a structural surplus target. The government of Montenegro can determine the exact percentage of the surplus, first in view of the speed at which it seeks to achieve the sustainable debt target and, second, in view of the GDP growth. In order to avoid slippage on the revenue side through enacted tax relief and tax expenditures, such a rule could be combined with a pay-as-you-go rule for the revenue side of the budget.

3. Parliamentary approval

3.1. The budget committee

According to the Parliamentary Rules of Procedure, the Committee of Budget, Economy and Finance (the budget committee) is the responsible standing committee for considering the budget proposal and the final accounts of the Republic. In addition, the Constitutional Issues and Legislative Committee can consider any bill.

The budget committee is one of 12 standing committees. It consists of 13 Members of Parliament representing all political parties, and is chaired by a member of the opposition. The largest party participating in the government appoints the vice chair. The budget committee is responsible for adopting the budget of Montenegro and scrutinising the accounts of the budget. The committee is also responsible for the consideration of all bills concerning financial and economic subjects, including market competition, business regulation, capital investments, natural resources, energy, mining, industry, maritime affairs, transport and trade activities, taxes, customs, banks, securities, lending and borrowing by the state, insurance of property and persons, lotteries, and property regulation.

The staff of the committee consists of a secretary, an advisor, and two junior assistants. The committee is mostly occupied with day-to-day duties such as protocols of meeting and procedural matters. Thus, committee members mostly draw on their political parties' views and the materials submitted by the government. The budget committee lacks technical staff who could provide analytical support.

3.2. Parliamentary budget procedure

According to Article 24 of the Organic Budget Law (OBL), the government adopts the proposal for the Law on the State Budget (the "budget bill") and sends it to Parliament in November. According to Article 28 of the OBL, Parliament must adopt the state budget by 31 December.

This timing gives Parliament between one and two months for analysis and discussion, which is somewhat less than the three months recommended by the OECD (2002). If the budget is not adopted in time, the Ministry of Finance approves funds on a monthly basis for the spending units of up to one-twelfth of the actual expenditures of the last fiscal year until the budget is adopted.

The Parliamentary Rules of Procedure do not contain any details regarding the consideration of the budget bill, apart from general rules that apply to all bills. According to Article 137 of the Rules of Procedure, all Members of Parliament and all committees receive all bills and may send opinions and amendments to the responsible line committee.

The budget documentation submitted to Parliament includes, in addition to the budget bill, a general part with an overview of total revenues and expenditures (split into current and capital expenditures), the surplus/deficit, and the budgetary reserve. The specific part consists of information on the separate appropriations with sources of funding. The documentation also includes an indicative forecast of expenditures for the following three fiscal years, including expenditures on the basis of multi-year commitments and investment programmes.

Upon reception of the budget bill and the accompanying documentation, the budget committee undertakes efforts to scrutinise the proposal by inviting participants from unions, chambers of commerce, universities, non-governmental organisations, the Central Bank of Montenegro and the State Audit Institution to its working sessions in November/December. The committee also invites the Ministry of Finance and relevant line ministries. This gives the government an opportunity to express its views on proposed amendments. The committee closes this phase (the first reading, only in the budget committee) by submitting a report to the Parliament 24 hours before the general debate related to the constitutionality of the bill and its compliance with European law (second reading).

If the budget bill is adopted in plenary session, the president of the Parliament invites the budget committee to consider the bill and the proposed amendments and to report within two days at the latest for a consideration of the separate appropriations (third reading).

In theory, the budget bill can be rejected in the first reading and sent back to the government, but this has never happened in practice.

The third reading starts with a presentation by the budget committee's rapporteur of the report in the plenary session. The amendments that the committee accepted and included in its report are usually not disputed anymore, whereas those rejected by the committee have to be explained and defended by the sponsoring Members of Parliament. Usually, only a few (less than five) of the proposed amendments are accepted by the Committee. Rejected amendments are generally not accepted in the plenary session. The total impact of the amendments approved in the plenary session is very limited. In addition, the amendments in recent years only concerned shifts between spending units rather than increases of the total funds proposed by the government. This self-restraint is not based on any legal restriction of the Parliament's competence. It rather reflects the political reality that the ruling parties support the government on the substance of the budget proposed by the government. As a result, the budget as adopted by Parliament only differs very little from the bill proposed by the government.

Parliament is not involved in the monitoring of budget execution once the budget year has started. In 2010, Parliament received for the first time a report from the Ministry of Finance for information.

3.3. Conclusion

As in many OECD countries, the impact of Parliament on the budget is limited in Montenegro. Particularly, Parliament generally does not change the totals of revenues and expenditures, which contributes to budgetary discipline and control.

The Parliament in Montenegro is given from one to two months to scrutinise the budget bill, which is too little in light of the "OECD Best Practices for Budget Transparency" (OECD, 2002). Three months prior to the start of the fiscal year is considered to be a minimum period to allow Parliament to review the draft budget properly. Therefore, it is recommended to the Montenegrin authorities to advance the submission of the budget bill to Parliament in the budget calendar (by 1 October) in order to increase the transparency of the budget procedures and adhere to best practices.

The government and Parliament of Montenegro may wish to consider enhancing the analytical capacity of the Parliamentary Committee of Budget, Economy and Finance (the budget committee) by allowing a modest extension of its staff to include a few public finance experts. This reform could contribute to better scrutiny of the budget, enhance the independent role of Parliament in the budget process, and increase the effectiveness and efficiency of public spending.

4. Budget execution

4.1. Organisation of budget execution

Budget execution is primarily regulated by the Organic Budget Law (OBL). Secondary legislation is provided by the Instructions on State Treasury Operations which include detailed rules on the practical aspects of budget execution and cash management.

The State Treasury Department ("Treasury") of the Ministry of Finance consists of 28 employees. The head of the department is a deputy minister. The Treasury is divided into five divisions, including the Accounting Services and Budget Execution Division, and the Debt and Cash Management and International Relations Division.

The Treasury is in charge of the single treasury account (STA), also called treasury consolidated account, which was established in 2002. Gradually more and more of the financial operations of the central government sector have been transferred to the account. As of January 2010, all five formerly extrabudgetary funds have been integrated into the state budget and thus have become a part of the STA. Excluded from the STA are donor-funded projects and IPA funds from the EU (Instruments for Pre-Accession), for which payments are handled through special procedures.

According to officials of the Ministry of Finance, there have been discussions to integrate the 21 municipalities of Montenegro in the STA, but no decision has been taken yet. Currently the municipalities have their accounts in commercial banks. The Ministry of Finance monitors the budget execution of the municipalities' budgets through periodical reports. According to Article 37 of the OBL, budget execution in the municipalities has to be carried out "in accordance with the manner prescribed by [the OBL] for execution of the state budget". Furthermore, the Ministry of Finance must approve any loans or guarantees issued by the municipalities. In daily cash management, however, the municipalities are independent.

There are some 124 spending units (budget holders), including the 16 (core) ministries, that are entitled to make payments or incur commitments. Every spending unit has a chief finance officer (usually the head of the unit, or the minister in the case of ministries). By written authorisation, the chief finance officer can delegate spending or commitment authority to other officials.

The Treasury keeps a tight control over budget execution. In OECD countries, this is not always the case. In a number of OECD countries, the responsibility for fiscal discipline is to a large degree transferred to the line departments. In those countries, preventive commitment and spending control is the exclusive responsibility of the finance officer of budget holders, and the role of the treasury is limited to cash management. However, the viability of such an arrangement is dependent on the strength of the finance divisions of the spending units and on a clear definition of the rights and obligations of the budget holders (including public internal financial control and internal audit). Moreover, this distribution of responsibilities can only be effective in a political context that puts heavy sanctions on violations of the rules of budgetary discipline. Montenegro may ultimately move in that direction, but for the near future the role of the Treasury in preventive control seems indispensable.

The Instructions on State Treasury Operations contain rules for *ex ante* control of payments as well as for commitments. The instructions specify that a spending unit can incur a commitment if it is in accordance with government policies and will make efficient and effective use of the state funds (Article 31 *juncto* Articles 27 and 28). Subsequent payment requests have to be approved and certified within the spending unit by a finance officer, entered into the SAP accounting IT system (Statutory Accounting Principles), and sent to the Treasury (Articles 26-28 and 43-45). Even though all payment orders are entered into the SAP IT system, the actual orders still arrive at the Treasury in hard copy. In the Treasury, a finance officer responsible for control verifies that the payment request is duly completed by the spending unit. Lastly, an authorising officer of the Treasury will make the final control of the payment before it is executed.

In principle, the instructions also foresee preventive commitment control. For each commitment, a commitment authority form must be approved and certified by the spending unit and submitted to the Treasury. According to Article 33 of the Instructions on State Treasury Operations, a spending unit must reserve a sufficient portion of its appropriations to meet commitments at the moment they are incurred. Commitments at the expense of future years are allowed only under strict conditions (Article 31 of the OBL) and have to be included in the budget forecasts for the coming three years, which are part of the budget documentation. Furthermore, according to Article 11 of the OBL, all commitments are to be recorded in the Treasury General Ledger. Crucially, however, the instructions do not foresee an approving role for the Treasury and do not require that a record be made within the SAP IT system. Apart from the hiring of staff (to be approved by the Budget Department), commitments leading to expenditure in the budget year are not being systematically checked for compliance with current appropriations, and commitments leading to expenditures in future years are not systematically registered.

Typically, only the Article 38 reports of spending units on unpaid liabilities by the end of January reveal the extent of the payment arrears accumulated during the year and the liabilities incurred for future years. In each of the last two fiscal years, arrears amounted to EUR 40-50 million, equivalent to 3-4% of total budget expenditures.

An example of an institution systematically creating payment arrears is the Health Insurance Fund. In 2010, the Ministry of Finance took over EUR 14.8 million of the payment arrears of the fund. But the level of arrears of the fund was reduced by only EUR 6 million, which means that arrears of around EUR 9 million were created during the course of the budget year.

Various observers have drawn attention to the problem of central commitment control (for example, the World Bank in the public expenditure and financial accountability report of 2009 and the State Audit Institution of Montenegro in its annual report of 2010).

There are holes in the legislation (no preventive control by the Treasury on commitments) and deficiencies in the implementation (no complete registration and reporting of commitments at the Treasury and no complete reporting in the budget documentation on commitments at the expense of future years).

4.2. Cash management

Annual spending plans are submitted by the spending units to the Treasury. The spending plans are approved for the entire year. On the basis of spending plans and forecasts of revenue flows, the Treasury prepares annual cash-flow plans which are then broken down into monthly written authorisations (or warrants) for the spending units. Subsequently, the spending units are allowed to spend within the monthly ceilings of their warrants. The warrants are recorded in the Treasury General Ledger.

Every spending unit is attached to the government SAP IT system, introduced in 2003. The system provides IT support for all activities of the Treasury except public debt management, for which a special IT system is used.

In addition to the STA which is held at the Central Bank of Montenegro, the Treasury also handles some accounts that are held in commercial banks. Recently the number of accounts handled by the Treasury has increased. Special accounts have been created for different projects financed by external donors, such as the projects financed by IPA funds of the EU (Instruments for Pre-Accession).

The Treasury has some freedom in cash and debt management in order to increase efficiency and reduce costs. One example is that the Treasury can delay payments up to 30 days.

4.3. Reallocation

4.3.1. Reallocation between line items

There is very strict budgetary discipline in execution during the course of the budget year. The use of the SAP IT system with fixed limits on each line item in accordance with the annual budget law makes it impossible to overspend. The only items for which overspending can occur are debt payments and certain entitlements in the sphere of social security benefits.

However, the fixed spending limits are accompanied by some flexibility as to reallocation. According to the OBL, the spending units can reallocate up to 10% of each line item within the same spending unit with approval of the Ministry of Finance. Furthermore, 10% of each line item can be reallocated to other spending units with the approval of the Cabinet.

Because of the detailed budget classification (see Section 2 above), there are usually a rather large number of reallocations during a budget year: around 100 between line items within a spending unit and around 5-10 between line items in different spending units.

4.3.2. *Carry-overs between budget years*

Unused funds cannot be transferred to the next budget year, leading to a considerable degree of "December fever". Most OECD countries allow carry-over under certain conditions. These conditions differ between countries but have broadly the same objectives: to avoid hasty and inefficient spending in the last month of the year, to avoid building up stocks of unspent resources, and to ensure budgetary discipline by compensation requirements in the next budget year.

4.3.3. *Government Reserve Fund*

The state budget includes a line item which is referred to as a Reserve Fund, to be used for unforeseen and extraordinary expenditures. The government has delegated spending authority for this appropriation to the Ministry of Finance. In the 2011 annual budget law, the appropriation of the Reserve Fund is EUR 8 million, or 0.64% of total budget expenditures. The level of the Reserve Fund has been significantly reduced. In previous years, it was around EUR 20-25 million, or up to 2% of total budget expenditure. Since the motives for the use of the fund are not always obvious or transparent, the government could consider a further reduction or the abolition of the fund. The leeway that the Minister of Finance needs to broker interministerial reallocations should come from asymmetric compensation requirements rather than from the Reserve Fund.

4.3.4. *Supplementary budgets*

Supplementary budgets during the budget year are rather common in Montenegro. Normally, one supplementary budget is submitted to Parliament around half-way into the budget year. In the boom years of 2006-08, the supplementary budgets were used to increase spending in the light of revised tax revenue estimates. This action led to a strongly pro-cyclical fiscal policy. In 2009, the opposite situation arose. The effects of the global financial and economic crisis made the revenues plummet, forcing the government to reduce spending in a supplementary budget. In 2010, no supplementary budget was submitted to Parliament.

4.4. *Conclusion*

The organisation of budget execution and the procedures of cash management in Montenegro are generally in line with practice in OECD countries. By integrating the former large extrabudgetary funds into the state budget and the single treasury account, budgetary control and discipline have been strengthened.

The main problem in execution concerns the lack of commitment control, which produces arrears and burdens on future budget years. The problem should be addressed both at the level of legislation and the level of implementation. Commitments leading to expenditures in both the budget year and in future years should be subjected to preventive Treasury control. Commitments should be integrated in the SAP IT system. The Treasury should upgrade its registration of commitments and integrate commitments in the periodic financial accounts. The Ministry of Finance should make sure that commitments leading to expenditures in future years are reported in the budget documentation and taken into account in the forecasts for future years.

The government could consider further reducing or abolishing the Reserve Fund.

There is a reasonable degree of flexibility for the government as regards the reallocation of spending within and across spending units. Strengthening of multi-annual fiscal planning should reduce the need for supplementary budgets and enhance automatic stabilisation (see Section 2 above).

The present rule prohibiting carry-overs leads to increased expenditures in December (called "December fever" or "end-of-year fiscal party"). In order to reduce perverse incentives to this effect, the Montenegrin authorities may wish to reconsider the present arrangement and allow carry-forwards under certain restrictions. Such a carry-over regime could enhance intertemporal efficiency in the use of budget funds. The restrictions should make sure that carry-overs are compensated in the next budget year. This can be done by requiring approval of the Minister of Finance on a case-by-case basis, so that the Minister can see to it that compensation is provided (either at the cost of new spending from the budget margin for the next year or by requiring compensation from the line minister concerned).

5. Public administration and service delivery

5.1. Organisational structure

Montenegro is a unitary state with self-governing municipalities. The state administration comprises 16 ministries and 36 other units, called agencies (1 secretariat, 17 administrations, 10 bureaus, 6 directorates and 2 other agencies). The agencies are owned and financed by the ministries, and their budgets are integrated in the state budget. However, they can have a substantial degree of independence in their executive policy, dependent on their statutes.

The 16 ministries are the following:

- Ministry of Justice
- Ministry of the Interior
- Ministry of Defence
- Ministry of Finance
- Ministry of Foreign Affairs and European Integration
- Ministry of Education and Sports
- Ministry of Culture
- Ministry of Economy
- Ministry of Transport and Maritime Affairs
- Ministry of Agriculture and Rural Development
- Ministry of Sustainable Development and Tourism
- Ministry of Health
- Ministry for Human and Minority Rights
- Ministry for Information Society and Telecommunications
- Ministry of Labour and Social Welfare
- Ministry of Science

As well as the ministries and agencies, there are independent public bodies (such as the Parliament and the Office of the President), the judiciary, and a substantial number of public non-profit institutions (educational establishments, hospitals, etc.). In addition, there are the five state funds (formerly extrabudgetary, but now integrated into the state budget of Montenegro). Ministries, agencies, independent public bodies and state funds are spending units, but some agencies can have more spending units, so that the number of spending units (124) exceeds the number of ministries and agencies (52).

5.2. Public employment and the civil service

There are around 51 000 persons working in the general government sector (excluding employees in the state-owned enterprises) out of a total domestic employment of around 170 000. General government employment thus amounts to around 26% of total domestic employment. Compared to OECD countries, this is a high proportion since the OECD average is around 15%. However, the low OECD average is partly due to the fact that in some OECD countries educational and health-care institutions are wholly or partly outside the general government sector (financed by government but not controlled by government). Nevertheless, general government employment is also relatively high in Montenegro in comparison with countries where educational and health-care institutions are mostly within the general government sector.

Table 7. **General government employment in Montenegro in September 2009**

Numbers of persons employed

State administration (ministries, agencies)	11 600
of which: the national police force	*5 600*
Other public bodies financed by the state budget	3 300
of which: Parliament	*190*
The armed forces	*2 100*
Regulatory agencies (partly financed by fees)	1 100
Judiciary	1 900
Education	13 000
Health	8 700
Municipalities	11 300
of which: employed at local utility companies	*4 300*
Total general government employment	**50 900**

Source: Data from the Ministry of Finance of Montenegro.

The main laws regulating the civil service are the Law on Civil Servants and State Employees and the Law on Salaries of Civil Servants and State Employees (LSCSSE). Montenegro lacks a clear-cut definition distinguishing civil servants from other state employees. Varying definitions in different laws make it hard to draw a line. The state administration as defined by Montenegrin laws comprises the ministries and the agencies. In total, the state administration employs around 11 600 persons. This number may be taken as the most common estimate of the size of the civil service. Almost half of this number is employed in the national police force.

The two largest groups of public employees are employed in the educational sector (around 13 000) and the health sector (around 8 700). The municipalities employ around 11 300 persons, around 40% of whom work in local utility companies. In the judiciary, there are around 1 900 employees, and the armed forces employ around 2 100 persons.

Most civil servants at the national level are covered by the LSCSSE regarding salary grades and pay scales. There are also salary grades and pay scales within the municipal administrations which follow the same logic. The rest of the employees in the general government sector are paid on the basis of collective agreements. The public sector unions play a significant role (except within the state administration). Within the health and educational sectors, the unions negotiate with the line ministries. The impact of the agreements on the budget is large. At the moment, a revision of the LSCSSE is being prepared, since the government wants to introduce salary grades and pay scales in more areas of public employment with a view to better control over expenditures.

According to the LSCSSE, there are 36 salary grades. The compression ratio of the lowest to the highest salary is close to 1:6. All salaries are determined by grade and seniority coefficients which are multiplied by a salary base (changed on a yearly basis).

Box 4. **Strategy for Public Administration Reform 2011-16**

In April 2011, a "Strategy for Public Administration Reform 2011-16" was adopted by the government. The strategy has the following seven priorities:

1. **Consistency in the public administration system.** Reorganisation of the public administration to reduce the number of ministries and agencies from the current 52 in order to make it more efficient.
2. **Stabilisation of public finances** by reducing the number of civil servants/public employees and strengthening single salary policies.
3. **Improvement of the civil service** focused on strengthening capacity by improving civil servants' competence through education and professional development.
4. **Implementation of measures to improve the quality of regulations and strategic documents** to ensure the consistency of legislation. More use of regulatory impact assessments.
5. **Improving administrative procedures** in order to ensure the provision of quality administrative services to citizens.
6. **Improvement of the electronic management system for documents**.
7. **Inspection reform** to ensure better implementation of regulations and international standards.

The implementation of the strategy is expected to lead to the following consequences:

- Significant budget savings, which will cut public spending by 1% of GDP annually.
- Reduction of the number of employees by an average of 7% in public administration and public services and institutions.
- A more efficient administration at the state and local levels by reduction of regulatory risk and administrative burdens for citizens and businesses, which will result in savings of about EUR 60 million in the next five years.
- Reducing the "grey" economy by the inspection reform, which will increase GDP and budget revenues by over 3%, or almost EUR 100 million, by 2015.

Source: Government of Montenegro (2011), "Strategy for Public Administration Reform in Montenegro, 2011-2016", Ministry of Finance, Podgorica.

However, as observed by SIGMA (OECD, 2010), the system of remuneration is sometimes blurred by a variable top-up for “excellent” work, which is not awarded in a transparent way by lack of an appropriate procedure for performance assessment. Moreover, there are also signs of non-transparent and unregulated top-ups for participation in commissions and overtime work, and of compensations in kind in the form of cars and living accommodation.

Another opaque issue is the distinction between politicians and civil servants. Formally only the minister is a political appointee. However, the secretary-general within each ministry is factually a political appointee as well. In addition, the minister may appoint political advisors. A proposal to convert the positions of the secretary-general and the political staff into politically appointed positions is currently under consideration.

As has been noted by SIGMA, human resource management is a problematic area in need of reform. “Frequently, ministries and administrative bodies simply disregard legally binding procedures […]. Patronage networks, clientelism and politicisation thus dominate recruitment and promotion practices” (OECD, 2010, p. 6).

5.3. *Service delivery*

Service delivery, with regard to both collective and individual services, is dominated by the central government. Some collective services, including utilities, are also provided by the municipalities. Compared with most OECD countries, the extent of individual service delivery at the municipal level is limited.

According to Articles 32 and 33 of the Law on Local Self-Government, the municipalities are responsible for (*inter alia*) the following tasks:

- handling urban planning and regulating construction, land use, and local infrastructure;
- regulating and providing public transport;
- developing entrepreneurship and tourism development;
- local environmental protection;
- civil protection;
- water management;
- development of sports and libraries and cultural development.

Primary education, kindergartens, social assistance and elderly care – commonly areas of responsibility of local governments in OECD countries – are handled in Montenegro by the central government. Nothing restricts the possibilities for the municipalities to provide services in social protection, education and employment as well as social housing for persons in need. But these are not mandatory tasks, and generally these kinds of tasks are performed by the central government.

Normally, the municipalities are the owners of public utility companies dealing with waste and waste water management, water distribution and local public transport (gas and electricity companies are generally not owned by the municipalities).

5.4. *Public enterprises*

In Montenegro, there are 26 state-owned enterprises (SOEs) with at least a majority state ownership (including the Central Bank of Montenegro). The SOEs together employ around 8 500 persons or around 5% of total domestic employment. Since the 1990s, Montenegro has pursued a vigorous privatisation policy. The banking sector, the telecom sector and the oil industry are fully privatised. The Privatisation Council is the main body responsible for the oversight of the privatisation process.

In line with Montenegro's strong focus on privatisation, a majority of the 26 SOEs are on the list, in the Privatisation Plan for 2011, to be partly or fully privatised. Both the State Railway Company and the Port of Bar have been split up into different companies with the aim of privatising the parts providing services while keeping the infrastructure under state ownership.

However, in the current situation some of the companies or parts of companies that are to be privatised have a bleak outlook for making profits, and the interest in buying these companies is rather weak. The same applies to the public utility companies owned by the municipalities.

5.5. *Public procurement*

A new procurement law is currently being drafted. The law aims to comply with EU directives and will be submitted to Parliament in the coming months. In line with the EC Directive 17/2004, the utilities sector will be covered by the law. The procedures for complaints will be improved and the responsibilities of the Public Procurement Commission (an independent body which hears complaints) will be extended to include the preventive control of tenders or procedures with a value exceeding EUR 1 million. Although the law still has to be approved by Parliament, its implementation is already under way.

The new law will also include some simpler procurement procedures and shorter deadlines in order to increase efficiency. The new law distinguishes seven types of procurement procedures, with thresholds as indicated in Table 8.

Table 8. **Thresholds of procurement procedures**

Procedure	Threshold	Value 2009 (EUR millions)	Per cent of total (2009)
Open procedure of public procurement	> EUR 10 000 (goods and services) > EUR 30 000 (works)	304.6	70.3
Restricted procedure of public procurement	> EUR 10 000 (goods and services) > EUR 30 000 (works)	1.4	0.3
Negotiated procedure of public procurement	> EUR 10 000 (goods and services) > EUR 30 000 (works)	48.3	11.1
Award of contract by entering into framework agreement	> EUR 10 000 (goods and services) > EUR 30 000 (works)	45.5	10.5
Direct solicitation of tenders (shopping method)	EUR 2 000 – 10 000 (goods and services) EUR 2 000 – 30 000 (works)	11.8	2.7
Direct agreement	< EUR 2 000 (goods and services) < EUR 2 000 (works)	17.3	4.0
Design contest	–	4.5	1.0

Source: Data from the Public Procurement Commission of Montenegro.

The total value of public procurement in Montenegro in 2009 amounted to EUR 433 million or 14.5% of GDP. The distribution across different types of procurement was: goods 35.7%, services 12.7% and works 51.6%.

The Public Procurement Directorate is an agency of the Ministry of Finance. Its tasks include: implementing the Public Procurement Law; monitoring; approving the use of specific procedures; advising contractors on procedures; and compiling statistics. All tenders and other documentation regarding the procurement processes are published on the website of the Public Procurement Directorate. The Public Procurement Directorate has around 20 employees.

The Public Procurement Commission has a board of three people, a director, and eight staff, making a total of 12 persons. However, the commission will need to hire more personnel in order to implement the new law.

Every ministry and agency is obliged to have a public procurement officer who is responsible for the procurement processes within the ministry or agency. In addition, there is a board in each procuring ministry or agency which decides on the procurement contracts.

The number of complaints has risen dramatically during 2010 and 2011. According to the Public Procurement Commission, this situation is due to better-educated suppliers who question the processes more rigorously. The view of the Public Procurement Commission is that the well-designed regulation in line with EU standards will substantially reduce corruption.

Even though legislation will be improved considerably, its implementation will still require large efforts. According to the latest annual report of the State Audit Institution of Montenegro (covering the period October 2009 to October 2010), contractors still use unrealistic public procurement plans. In addition, the organisation of procurement inside contracting ministries and agencies is not yet in accordance with the new law, the choice of procedures is not always in line with the applicable criteria, and procurement reports are not complete or not very informative.

5.6. Conclusion

General government employment in Montenegro is relatively large compared to OECD countries, even taking into account that education and health care are mostly provided by the government. In this light, the emphasis placed by the government on reducing the number of civil servants and employees is understandable and legitimate.

Human resource management is an area in need of reform. This problem is recognised by the government, but progress is slow and efforts could be stepped up. Priorities include: a clear definition of the civil service, a clear distinction between political appointees and civil servants, a more uniform regulation of remuneration, a reduction of variable salary components, improved procedures for recruitment and promotion, and more uniform and objective procedures for performance assessment.

The organisation of the state administration is complex. Clear criteria are lacking for the attribution of the status of agency, public body and public non-profit institution.

Public employment statistics should be based on clear definitions of types of employees and types of public organisations.

The "Strategy for Public Administration Reform 2011-16" comprises many laudable objectives but lacks focus and a clear implementation plan.

The privatisation policy should be pursued with vigour. Once market conditions improve, rapid progress in this area should be feasible.

The public procurement legislation is consistent with European standards. The next phase of the procurement reform should be focused on implementation. Particularly the progress on the implementation of regulations concerning the organisation of procurement activities in the spending units could be stepped up. The comments in the report of the State Audit Institution provide useful suggestions.

6. Accounting and audit

6.1. Accounting

The accounting basis for the government accounts is cash, with some elements of accruals introduced in the latest revision of the OBL[13] thereby implementing a recommendation of the State Audit Institution contained in its 2006 annual report. The government plans to introduce full accrual accounting with the help of a twinning project.

All spending units keep their own accounts. There is a single Chart of Accounts, in line with *Government Finance Statistics 2001* (IMF, 2001), applicable to all budget units under the sole responsibility of the Ministry of Finance. The accounts are consistent with the line items of the budget. Current reform plans envisage a further specification by subdividing certain line items such as "contractual services" which typically account for over 50% of spending units' expenditure. The aim is to increase the transparency of the budget and to enhance budget planning and execution control by the Ministry of Finance (see Section 2.1.2 above).

The Treasury provides and publishes monthly and quarterly reports and a final annual report on budget execution. Furthermore, reports are issued on internal debt and external debt on a quarterly basis. Financial reports do not cover commitments (see Section 4.1 above).

6.2. Internal audit

Following EU recommendations aiming to introduce public internal financial control (PIFC), internal audit was reformed from a centralised support service, co-ordinated by the Ministry of Finance, to a decentralised service. While 20 internal audit units have already been established by the larger spending units on the basis of the new PIFC law and the ensuing regulations (with a total staff of 16 internal auditors; some units have no staff yet), no consolidated internal audit reports have been produced so far. By the end of 2011, the central harmonisation unit in the Ministry of Finance (the Department for Harmonisation of Financial Management and Internal Audit, DHFMIA) expects to receive the first annual reports of those units that are already operational. It is expected that this will provide information on the degree of compliance of spending units with internal procedures and regulations, and on the overall effect of the audits (number of audits, rate of implementation of recommendations, etc.). On this basis, the DHFMIA will formulate a consolidated report to the government on the implementation of public internal financial control. With two divisions (financial management control with two employees, and internal audit with three employees), the DHFMIA is responsible for developing methodology and guidelines, formulating recommendations for the improvement of financial control, and advising the spending units and the decentralised internal audit units accordingly. The DHFMIA will also develop an internal audit examination in order to accredit authorised internal auditors.

The internal audit unit has to be independent from all other units within the spending unit. The head of the spending unit will receive the annual report on the work of internal audit, comprising an assessment of the adequacy and effectiveness of financial management and control arrangements as well as reports on the results of each individual audit and all major findings and recommendations for improving the spending unit's operations. In addition, the audit units will provide periodic reports on the implementation of internal audit annual plans, reports on all cases where activities of internal auditors have been confronted with restrictions, and a report on adequate resources for the conduct of internal audit (Article 28 of the PIFC Law).

Ultimately, internal audit is expected to be carried out by 30 internal audit units (including eight in the larger municipalities) staffed with three auditors each, thus amounting to 90 internal auditors. Given the size of the Montenegrin government, the need to reduce the number of public employees (by one-third of total employment, according to current plans) and the comparatively small State Audit Institution (with 26 external auditors), doubts remain as to the cost-effectiveness of this sizeable and permanent increase to the public wage bill. In particular, while the spending units will gain better guidance in terms of improving their internal financial management and control arrangements, the reform seems too ambitious.

The OECD Secretariat recommends fundamentally reconsidering the reform. Effective internal audit requires in the first place a relation of confidence between the heads of spending units and internal auditors. For that purpose, it is necessary that internal auditors are highly qualified and able to identify risks in a timely fashion. Only under that condition will internal audit reports be taken seriously and be acted upon in an effective way. In this regard, it is not necessary to have many internal audit units or many auditors in every unit. To the contrary: too many internal audit reports will lead to audit fatigue. For a country the size of Montenegro, joint internal audit units (also called parent units) for several spending units could be an appropriate tool for using internal audit resources efficiently. The most relevant ministries (or large agencies) could have their own internal audit units with one or two highly qualified auditor(s). This arrangement could reduce the total number of internal units and internal auditors to the most optimal, which would be considerably below the current target of 30 units and 90 internal auditors.

6.3. External audit

External financial audit is the task of the State Audit Institution (SAI) which was established by the Law on the State Audit Institution of 2004.[14] In virtue of this law, the SAI is an autonomous and independent state authority which examines the regularity, effectiveness and efficiency of the operations of spending units subjected to external audit. Thus, the SAI performs both financial audits (focusing on the compliance of financial transactions with legislation and the reliability of the accounts) as well as performance audits (focusing on the effectiveness and efficiency of spending).

The Law on the SAI specifies that staff is divided into five sectors, each headed by a senator. The senators are appointed for an indeterminate period of duty by Parliament and can only be dismissed by court sentence or upon reaching retirement age or by own request. The president is selected by Parliament from among the senators, for a term of nine years. The SAI is thus organised following the collegiate model, similar to courts of audit in Germany. The five sectors are each responsible for different spending units:

- Sector I audits the final accounts of the government as well as, *inter alia*, the Ministry of Finance, the Tax Administration, and the Public Procurement Commission.
- Sector II is responsible, *inter alia*, for the audit of the Central Bank of Montenegro, the Parliament and the Office of the President, and the Ministry of Defence.

- Sector III is responsible for the Pension and Disability Insurance Fund, the Health Insurance Fund, ministries such as Health, Labour and Social Welfare, Agriculture and Rural Development, and Education and Sports, as well as *inter alia* for universities, the Forest and Water Administration, and the Red Cross.
- Sector IV is responsible for regulatory agencies, courts, non-governmental organisations, and the ministries of Justice and of the Interior.
- Sector V is responsible for local self-government and the ministries of Information Society and Telecommunications and of Sustainable Development and Tourism, as well as for state-owned enterprises.

Since November 2007, the SAI is a member of INTOSAI (the International Organization of Supreme Audit Institutions). The Law on the SAI is consistent with international standards. Full audit coverage of all public spending is foreseen. The annual audit plan is adopted by the SAI by 10 January every year without the need for governmental or parliamentary approval or discussion.

The SAI enjoys legal, functional, personal and financial independence. Yet SAI auditors fall under the application of the Law on Civil Servants and State Employees. Thus, limitations for hiring of public servants apply to the SAI as well, such as confirmation of availability of funds by the Ministry of Finance or pre-selection of candidates by the Human Resources Management Authority. In addition, the SAI observes the general rule of the Ministry of Finance that new employees can only be nominated for a period of not longer than two years (this does not apply to senators; see above). In view of the required autonomy of the SAI, the authorities may wish to consider exempting the SAI from the human resource regulations that give the government or the Ministry of Finance a say in the selection of SAI personnel or in the filling of recognised vacancies.

The resources of the State Audit Institution are determined by Article 51 of the SAI law which stipulates that they are provided by the state budget of Montenegro. According to the law, the Parliamentary Committee of Budget, Economy and Finance (the budget committee), upon a request from the SAI, sends the SAI budget proposal to the Ministry of Finance to be fed into the budget. This provision is currently under reconsideration, in line with EU recommendations to strengthen the financial autonomy of the SAI. Indeed, whereas in practice the SAI budget has increased every year since its establishment and has not been subjected to cuts as most other spending units, it also does not allow the SAI to increase its workforce in line with its formally agreed capacity of 58 positions.

Apart from the five senators, the institution currently has a cadre of 14 administrators and 31 auditors, including heads of departments, state auditors, junior auditors, and advisors – thus 45 staff in total. The shortfall of 25% of the 58 positions concerns only the state auditors. In other words, while all of the administrative posts are filled, 33% of the auditor positions are vacant.

In addition to the issue of independence, there is a labour market shortage of personnel with public sector auditing skills. The SAI thus mainly hires junior auditors – that is, young graduates who, after three years, are entitled to take the state auditor exam. The SAI was accorded by law the right to prepare a certification programme, to organise and assess the exam, to issue diplomas, and to accredit state auditors. The certification is open to all public employees and external professionals against a financial contribution. Until the end of 2010, 38 diplomas were issued, nine of which were given to non-SAI employees.

From 2009 to 2010, there was a slight increase in the number of audits carried out by individual auditors. In terms of coverage, 80% of all spending units have been audited at least once since the establishment of the SAI in 2004. By the end of 2012, it is expected that the SAI will have audited all spending units under its mandate at least once. While in each of the last two auditing years one performance audit was conducted, the SAI has yet to develop a sufficient capacity for this type of audit.

The auditing process of the SAI is regulated by the Rules of Procedure and by the "Instruction on the Methodology of Work of the SAI" dating from October 2005, the latter being currently revised and complemented by guidelines for auditors. On the basis of the annual audit plan adopted by the senate, a collegium composed of two senate members supervises every audit. The chair of the collegium informs the auditee about the audit at least 15 days before the beginning of the field work, and holds the introductory discussion and the final meeting with the audited entity. Field work typically takes two weeks, and the average duration of an audit is three months.

It is the duty of the head of department to manage the audit work, supervise the work of the auditing team, and prepare the audit report based on the auditors' protocol of the audit. The collegium adopts the draft report, transmits it to the audited entity for comments within 15 days, and adopts the final report after considering potentially disputable facts. The report is presented to the senate of the SAI, to the auditee and, in the case of substantial financial impact, to the Ministry of Finance. Typical findings by the SAI are that spending units lack knowledge about the implementation of the annual budget law, the procurement provisions, and other regulations. The reports contain recommendations and a time frame for corrections, as well as the request by the SAI to be informed of compliance with these recommendations. In the case of no response to the recommendations, the collegium can suggest that the senate carry out a control audit.

Audit results are transparent, with the reports being published and made available on the Internet homepage of the SAI. However, they are not transmitted to Parliament. Parliament is informed by means of extracts from the reports with main facts and recommendations in the SAI annual report. There is a good spirit of co-operation between the parliamentary budget committee and the SAI. As there is no legal obligation for the government to respond to findings and recommendations by the SAI, Parliament may adopt the recommendations contained in the SAI annual report as conclusions and ask the government to comply with them. The SAI may wish to consider sending its audit reports directly to the Parliament after they have been released, as is usual in most OECD countries.

As a follow-up mechanism, the SAI provides a summary in the next annual report of the implementation of the previous year's recommendations, including an appraisal of the answers provided by the responsible ministries or agencies.

However, as the SAI annual report for the period October to October is typically discussed in November, at a time when the budget bill is already submitted to Parliament, there is only very limited time available for a detailed analysis and consideration of the SAI report. In order to highlight the political importance of compliance with the conclusions, it is planned that in 2011 a separate session of Parliament will be held before the summer break devoted only to the follow-up of the SAI recommendations.

Parliament adopts the Law on the Final Accounts after considering the SAI report on the final accounts. The Organic Budget Law (OBL) states that the draft law should be submitted together with the final accounts, as reported by the SAI, by the end of September. The OBL does not foresee a separate report on the annual final accounts. Nevertheless, over the last five years, the SAI submitted a separate report on the final accounts to Parliament in September (twice at the end of July), followed in October by its annual report with a summary of its statements on the final accounts.

6.4. Conclusion

Current reform plans envisage a further specification of the Chart of Accounts, by subdividing certain line items such as “contractual services” which typically account for over 50% of spending units’ expenditure. The aim is to increase the transparency of the budget and to enhance budget planning and execution control by the Ministry of Finance. This is a commendable initiative, but the authorities should make sure that this does not lead to a further increase of the number of line items – which is already quite large – but preferably to a decrease. Smaller line items can be merged.

The OECD Secretariat recommends fundamentally reconsidering the reform of internal audit. Effective internal audit requires in the first place a relation of confidence between the heads of spending units and internal auditors. For that purpose, it is necessary that internal auditors are highly qualified and able to identify risks in a timely fashion. Only under that condition will internal audit reports be taken seriously and be acted upon in an effective way. In this regard, it is not necessary to have many internal audit units or many auditors in every unit. For a country the size of Montenegro, joint internal audit units (also called parent units) for several ministries and/or agencies could be an appropriate tool for using internal audit resources efficiently. The most relevant ministries (or large agencies) could have their own internal audit units with one or two highly qualified auditor(s). The exact numbers of audit units and auditors are to be decided by the Montenegrin authorities depending on the needs of each ministry or agency, but the total number of 90 internal auditors in spending units is far too big.

External audit results are transparent and of satisfactory quality, with the reports being published and made available on the Internet homepage of the State Audit Institution. However, the reports of separate audits are not transmitted to Parliament and in fact reach Parliament only via summaries in the annual audit report. The SAI may wish to consider sending its audit reports directly to the Parliament after they have been released, as is usual in most OECD countries.

There is a shortfall of 25% of the 58 positions in the State Audit Institution. Around one-third of the auditor positions are vacant. The senate of the SAI tries to fill the vacant positions in a responsible way. In view of the size of the Montenegrin government, there seems to be no need to extend the staff of the State Audit Institution beyond its formal strength of 58 positions. However, in view of the required autonomy of the SAI, the authorities may wish to consider exempting the SAI from the human resource regulations that give the government or the Ministry of Finance a say in the selection of SAI personnel or in the filling of recognised vacancies.

Notes

1. Based on IMF (2011a) and Economist Intelligence Unit (2011).
2. Based on IMF (2011a) and Economist Intelligence Unit (2011).
3. Based on Economist Intelligence Unit (2011).
4. Based on Economist Intelligence Unit (2011).
5. Based on IMF (2011a) and OECD (2010).
6. Based on IMF (2011a) and Economist Intelligence Unit (2011).
7. This weakness was also highlighted in the public expenditure and financial accountability report of the World Bank (World Bank, 2009).
8. For further information on the benefits of medium-term budgetary frameworks, see the European Commission: *http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm*.
9. *OECD International Budget Practices and Procedures Database*, *www.oecd.org/gov/budget/database*.
10. Note, however, that this argument is weaker in the Swedish model, in which the margin between the ceiling and the sum of baseline estimates is only distributed for the upcoming budget and kept in reserve for future years, than in the Anglo-Dutch model in which the margins (if any) are filled for all future years of the framework with new spending at the moment when the framework is decided.
11. An example of an expenditure rule is the EU "principle of prudent fiscal policy making" in the recent package of reinforced fiscal governance measures. Under this principle, a country should not increase its expenditure faster than the rate of structural GDP growth, and if there is a threat of deviation from debt sustainability, its rate of expenditure increase must be significantly lower than the economic growth. The principle does not take account of the need for temporary debt reduction in ageing societies.
12. The structural fiscal balance is obtained by removing the cyclical component from the headline fiscal balance. The cyclical component, in turn, depends on two factors: the size of the output gap; and the output elasticity of the tax yield, which indicates the extent to which the tax yield reacts to fluctuations in GDP. The determination of the output gap is not always an easy exercise, particularly in a small and open economy such as Montenegro. In order to avoid political discussions about the calculation procedures, it may be useful to resort to a rule of thumb that defines the distinction between structural and cyclical fluctuations in terms of a band around the revenue trend (see the fourth bullet point in Section 2.3.2 above, where this approach was also recommended as a criterion for the adjustment of the MTEF).
13. An urgent problem that needs to be solved for both budgeting and accounting is the treatment of arrears in tax collection. This problem is not yet resolved in the OBL. In ESA95 (Eurostat, 1996), one option that is advocated is to multiply the total sum of the arrears with an appropriate coefficient to reduce the amounts to be recorded. This coefficient should be based on past experience and current expectations. The rationale is that it would be improper to record full future revenues when it is clear that some share will never be paid in.
14. With the constitutional reform of October 2007, the State Audit Institution was anchored in the Constitution. Article 144 reads: "The State Audit Institution is the independent and supreme authority of national audit." The Constitution tasks the SAI with both financial and performance audit of the management of state assets and liabilities, budgets and all the financial affairs of the entities financed by public means or in possession of state property. The Constitution also establishes an annual reporting obligation to Parliament.

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