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ABBREVIATIONS AND ACRONYMS

APML	Administration for the Prevention of Money Laundering
BB	Budget Beneficiaries
BEEPS	Business Environment and Enterprise Performance Survey
BLI	Baseline Indicator Study
BSL	Budget System Law
CARDS	Community Assistance for Reconstruction, Development and Stability
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
CFAA	Country Financial Accountability Assessment
CFO	Chief Financial Officer
COA	Chart of Accounts
COFOG	Classification of the Functions of Government
COSO	Committee of the Sponsoring Organization of the Treadway Commission
CPAR	Country Procurement Assessment Report
CPI	Corruption Perception Index
CPTR	Commission for Protection of Tenderers' Rights
DAC	Development Assistance Committee (OECD)
DBB	Direct Budget Beneficiaries
DFID	Department for International Development (UK)
DI	Donor Indicator
DPL	Development Policy Lending
EA	Extended Agreement
EAR	European Agency for Reconstruction
EBF	Extra-Budgetary Funds
ECA	Europe and Central Asia Region, World Bank
ECSPE	Europe and Central Asia Region, Poverty Reduction/Economic Management Department, World Bank
ECSPS	Europe and Central Asia, Operations and Policy Services, World Bank
ECCU	Europe and Central Asia Country Unit
EPS	Electricity and Power supply of Serbia
ESA	European System of Accounts
ESW	Economic and Sector Work
EUR	Euro
FAU	Fiduciary Assessment Update
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FI	Financial Intelligence Unit
FMIS	Financial Management Information System
FMS	Financial Management Specialist
FY	Fiscal/Financial Year
GDP	Gross Domestic Product
GSF	Government Financial Statistics
GSFM	GFS Manual
HIPC	Heavily Indebted Poorest Countries
IAS	International Accounting Standards
IAU	Internal Audit Unit
IBRD	International Bank for Reconstruction and Development
IBB	Indirect Budget Beneficiaries
ICTY	International Criminal Tribunal for the Former Yugoslavia
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
ISPPIA	International Standards for the Professional Practice of Internal Auditing
ISDACON	Inter-Sectoral Development and Aid Co-ordination Network
ITLS	Interim treasury Ledger System
JAT	National Airline of Serbia (Yugoslavia)
MOF	Ministry of Finance
MSA	Mutual Services Agency
MSSO	Mandatory Social Security Organization
MTEF	Medium Term Expenditure Framework
MTS	Modernized Treasury System
NBS	National Bank of Serbia
NGO	Non-Governmental Organization
NIS	National Oil and Gas Company of Serbia
OECD	Organization for Economic Cooperation and Development
OG	Official Gazette
OPCS	Operational Policies and Country Services, World Bank
OSCE	Organization for Security and Cooperation in Europe
PAA	Public Payment Agency
PEFA	Public Expenditure and Financial Accountability
PEIR	Public Expenditure and Institutions Review
PEM	Public Expenditure Management
PFM	Public Financial Management
PFMA	PFM Assessment
PHRD	Policy and Human Resource Development
PI	Performance Indicator
PIFC	Public Internal Financial Control
PIU	Project Implementation Unit
PPO	Public Procurement Office
PPFDPC	Programmatic Private and Financial Development Policy Credit
PPL	Public Procurement Law
PREM	Poverty Reduction and Economic Management
PRS	Poverty Reduction Strategy
PSDPL	Public Sector Development Policy Loan
PTT	Postal company of Serbia
ROSC	Reports on the Observance of Standards and Codes
RSD	Serbian Dinar
RTGS	Real Time Gross Settlement
RTS	National Television of Serbia
SAA	Stability and Association Agreement
SAI	Supreme Audit Institution
SAC	Sectoral Adjustment Credit
SAM	Serbia and Montenegro
SAP	Stability and Association Process
SBD	Standard Bidding Documents
SIGMA	Support for Improvement in Governance and Management
SSOE	Socially or State-Owned Enterprise
TA	Technical Assistance
TAPL	Tax Administration and Procedures Law
TSA	Treasury Single Account
TSS	Transitional Support Strategy
TTL	Task Team Leader
USAID	United States Agency for International Development
VAT	Value Added Tax
ZOP	Clearing and Settlements Bureau in ex-Yugoslavia
ZTP	State Railroad of Serbia

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PREFACE

The primary objective of the Public Financial Management Assessment is to provide an assessment of the strengths and weaknesses of the PFM system in the Republic of Serbia, which can help the government to prioritize and measure progress in Public Financial Management reform. As stated in the Country Assistance Strategy for Serbia, a "single, integrated Public Financial Management (PFM) report" shall be produced in the World Bank's Fiscal Year 2006, which will draw on previous analytical work, including the findings of recent Bank studies: the updates of the 2002 Public Expenditure and Institutional Review (PEIR), the Country Financial Accountability Assessment (CFAA)[1] and the Country Procurement Assessment report (CPAR)[2]. The updates, including the combined CFAA and CPAR Fiduciary Assessment Update (FAU) were completed in 2005.

The assessment is based on the Public Financial Management performance indicators developed by PEFA[3]. The 28 PFM performance indicators and 3 donor indicators are assigned a score from A-D with "A" reflecting high performance and "D" low performance, with "B" and "C" as intermediate scores. The scores are assigned in accordance with the interpretations and the scoring methodology provided by PEFA[4].

The World Bank team has coordinated closely with the donor community in Serbia. The Ministry of Finance was engaged from the outset at a very senior level. The work on technical issues and requests was based on contacts with technical level officials who demonstrated willingness to share with the Bank all relevant reports and data. The donors most active in the field of PFM have been closely involved, both in designing and assuring the quality of the Assessment. Cooperation has been particularly close with the IMF, the European Agency for Reconstruction (EAR), the UK Department for International Development (DFID) and the Norwegian Ministry of Foreign Affairs.

The PFM Assessment focuses mainly on the central government institutions (Direct Budget Beneficiaries) of the Republic of Serbia and the main Extra-Budgetary Funds (EBFs). Although the PFM Assessment (PFMA) does consider issues related to the integration of "Indirect Budget Beneficiaries" into the Treasury system, the main focus of the report is on the functioning of the Direct Budget Beneficiaries (DBBs) within central government and the Mandatory Social Security Organizations (MSSOs)[5].

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[1] Federal Republic of Yugoslavia Country Financial Accountability Assessment, December 15, 2002.
[2] Federal Republic of Yugoslavia Country Procurement Assessment Report, June 2002.
[3] "PEFA" stands for Public Expenditure and Financial Accountability and is a partnership program of the World Bank, the European Commission, the UK Department for International Development, the Swiss State Secretariat for Economic Affairs, the French Ministry of Foreign Affairs, the Norwegian Ministry of Foreign Affairs, and the International Monetary Fund. The PEFA secretariat is located at the World Bank's headquarters in Washington DC.
[4] See Annex I for scoring methodology. The detailed interpretation used to score the indicators in this assessment are provided from the PEFA web-site: http://www.pefa.org
[5] These include the: (i) Republic Health Insurance Institute; (ii) Republic Pension and Disability Insurance Funds (including the funds for the employees, farmers and entrepreneurs); and (iii) Republic Labor Market Office. These are referred to in the BSL as the "mandatory social security organizations" (MSSOs).

Information was gathered through a combination of on-the-spot interviews and analysis of publicly available data and reports. For the collection of data, the PFMA team relied on information obtained in connection with the work on the FAU and interviews conducted during the course of a mission to Belgrade. In addition, local country-based staff held several additional meetings in order to clarify some of the outstanding issues. A list of interviewees is available in Annex II of this report. The data needed for the quantitative analysis was obtained directly from representatives of the MOF or publicly available sources, such as the MOF's website. The PFMA draws significantly on reports from the IMF, including Country Report No. 05/232 – Selected Issues and Statistical Appendix (July 2005) and Country Report No. 06/58 – Sixth Review under the Extended Arrangements etc. (February 2006). A complete list of references is provided in Annex III.

A World Bank team prepared the report following a mission to Belgrade **and follow-up work by local World Bank staff.** The team consisted of Tiana Mitrovic Kocovic (Economist), Aleksandar Crnomarkovic (Financial Management Analyst), Plamen Kirov (Procurement Specialist), Olav Rex Christensen (Senior Financial Management Specialist (Sr. FMS)) and Johannes Stenbæk Madsen (Sr. FMS, Task Team Leader (TTL)). A member of the team, Pascale Kervyn de Lettenhove (Sr. FMS), did not participate in the mission, but provided current feedback on the quality of drafts and made considerable contributions to the report.

The team would like to acknowledge the assistance of many people who contributed to the Assessment, including officials and staff of the Government of Serbia, the National Assembly and donor organizations. Thanks go to Deputy Minster of Finance, Vesna Arsic, and Vice-Chairman of the Finance Committee of the National Assembly, Radojko Obradovic, for their participation and input. Thanks also go to Vesna Dzinic (Assistant Minister and Head of the Treasury), Zivko Nesic (Deputy Treasurer, Head of the Public Payment Agency (PPA)), Assistant Ministers, Danica Magovac and Vlada Vukojevic (both Ministry of Finance), Predrag Jovanovic (Director of the Public Procurement Office), Lars-Andre Skari (Advisor to the Deputy Prime Minister financed by the Norwegian Government), George McLaughlin (DFID, Belgrade); Gianluca Vannini (EAR, Belgrade), Mila Konikovic (Organization for Security and Cooperation in Europe (OSCE, Belgrade), and Peter Doyle and Harald Hirshhofer (both IMF) for their valuable assistance. Special thanks go to Anna Ivanova (IMF) who provided much appreciated advice, data inputs and interpretations at critical stages of the drafting process. In addition, grateful thanks go to Country Director, Orsalia Kalantzopoulos, and to Country Manager, Carolyn Jungr, for engaging with the team. Further, the team would like to thank World Bank staff members John Hegarty, Siew Chai Ting, Pamela Bigart, Devesh Mishra, Manuel Vargas, Mathew Verghis, Mike Edwards, Matthew Andrews, Lazar Sestovic, Junghun Cho, William Dillinger, Nicola Smithers and Frans Ronsholt who offered much appreciated feedback and comments. Thanks also go to Desanka Stanic, who coordinated the FAU and PFMA assessment missions and data-collection; and to Sioban Farey who assisted with the editing of this report.

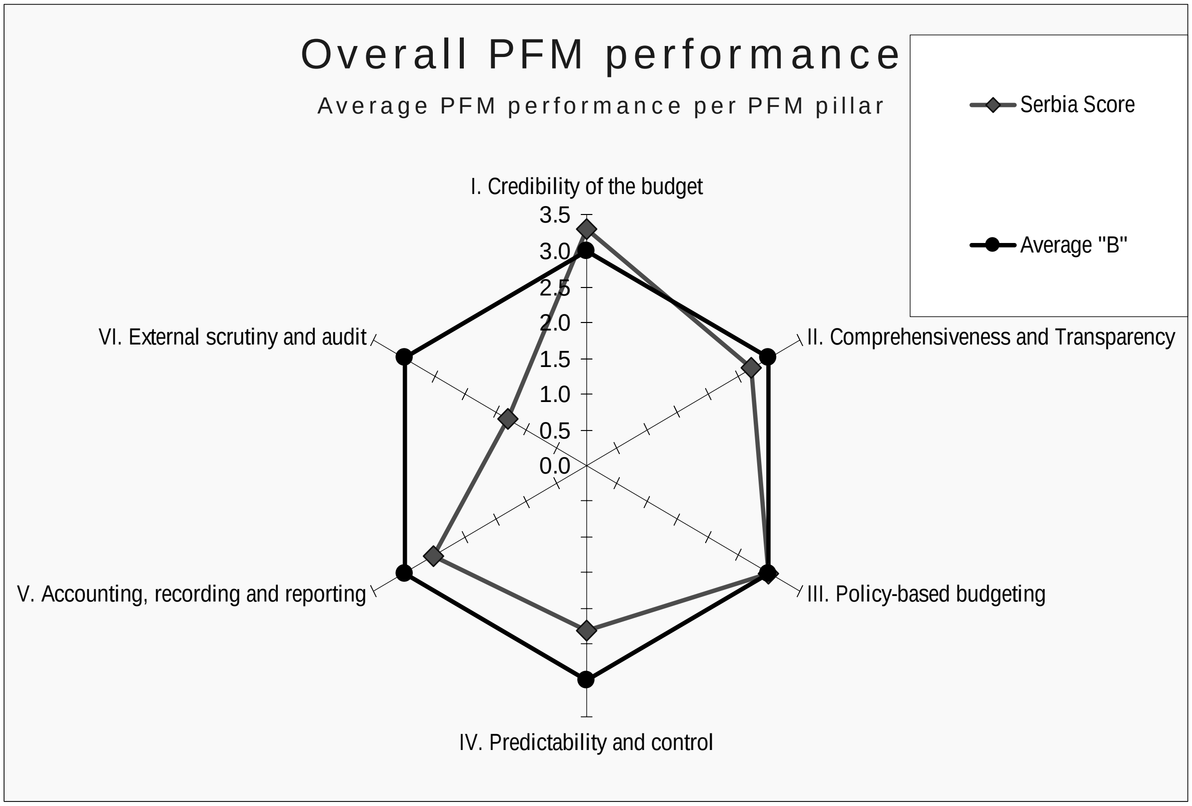
EXECUTIVE SUMMARY

1. This assessment of Serbia's Public Financial Management performance is based on 28 indicators developed by PEFA and organized around 6 pillars representing core dimensions of PFM performance (see graph below). PFM performance, as measured by PEFA indicators, informs of key outcomes in public expenditure management (fiscal discipline, allocative efficiency, and operational performance). PEFA assessments provide snapshots of a country's PFM performance allowing for international comparisons. Repeated assessments aim at assisting governments in monitoring the progress of PFM performance over time. The scores are assigned in accordance with the interpretations and the scoring methodology provided by PEFA[6].

2. **Overall PFM performance, as measured by the indicators grouped under the above six pillars for Serbia, is mixed** (*Figure 1*). Serbia scores well on Pillar III. This score reflects the fact that the budget preparation process supports the use of the budget as a policy tool. Serbia also scores reasonably well on Pillars I and II. While the government's annual financial statements have not been audited since 2001, the unaudited financial statements point tentatively to the conclusion that budgets are fairly reliable, transparent and comprehensive. Serbia's performance on Pillars IV, V and VI is weaker, suggesting that there is considerable scope for improvement in accountability, one of the corner principles of good PFM. Pillar IV assesses predictability of resources and control over budget funds; Pillar V assesses quality, availability, comprehensiveness and timeliness of fiscal accounts; and Pillar VI addresses the main elements of financial accountability.

[6] The assessment methodology used to measure indicators PI-1 – PI-28 is publicly available from the PEFA web-site: http://www.pefa.org.

***Figure 1. Compared PFM Performance*[7]**



3. Pillar I assesses the credibility of the budget based on revenue and expenditure outturns compared to budgets. **Numbers, which need to be confirmed by external auditing[8], point towards reduced variance between budgets and outturns for the central government budget over the past 3 years**. Absolute numbers for the Republican budget show that revenue outturns, while consistently above budget, have tended to become more realistic[9]. On the expenditure side, the government tightened fiscal spending from 29 percent of GDP in 2002 to 24.5 percent in 2005[10]. At the same time, variance between total budget and total expenditure outturns decreased for the Republican budget. The composition of outturns, compared to the original budget using an administrative basis, (ministries/agencies) has also improved considerably over the past three years.

[7] Caution should be exercised while using this figure. A simple average for indicators within each pillar has been used. The ratings A, B, C, and D have been converted into numbers: 4, 3, 2, and 1, without translating the "+", i.e. B+ is considered to be 3. Average numbers for the six pillars I to VI are: 3.3, 2.7, 3.0, 2.3, 2.5 and 1.3. Please refer to the full list of ratings at the end of the executive summary and the details for each indicator in the main text of the report.
[8] Reliability of data can be assessed based on independent assurance of their integrity. As external audit has not yet been performed on the government's budget, overall reliability of data is deemed uncertain.
[9] Since the indicator is based on absolute numbers, it does not reflect government's efforts in revenue collection. Total revenue of the Republican government increased from 24.7 percent of GDP in 2002 to 25.4 percent of GDP in 2005 (source: IMF).
[10] Republican budget, Source : IMF

4. The **total stock of expenditure arrears has been reduced significantly over the last 5 years as percentage of GDP. However it remains significant at around 4 percent of GDP at end 2005.** Moreover, if public enterprise arrears estimated at 1.6 percent of GDP in 2004 are added, total public sector expenditure arrears would be around 5 percent of GDP. **Maintaining arrears at such a level can seriously undermine credibility of the budget and introduce distortions in the economy.**

5. Pillar II assesses comprehensiveness and transparency of the budget**. In Serbia, considerable efforts have been made to increase availability of budget, but challenges remain with respect to the transparency of budget data, reporting on public expenditures, and data reliability**. Total government resources are the sum of different budgets: Republican, state union[11], provincial[12], local governments and EBFs. Some allocation processes could benefit from enhanced transparency, such as clearer justifications for subsidies to public enterprises. In addition, despite recent improvements[13], annual budget documentation lacks information on: (a) the composition of financial assets; (b) previous years' estimated outturns including justifications for discrepancies; and (c) explanations of budgetary implications of policy initiatives. This missing information is key to evaluating policy choices. Equally important is the explicit inclusion of information on classification of the budget along functional lines. These weaknesses blur the transparency of how government policies and priorities are translated into budget allocations.

6. Reporting on and monitoring of all public expenditure is the other side of the comprehensiveness and transparency equation. The team has assessed the comprehensiveness of fiscal transparency using the unpublished annual accounts, as well as the regular monthly Bulletin on Public Finances. **As mentioned above, these annual accounts have not yet been audited, presented to and approved by the National Assembly, and made publicly available. The current delay is due to the problems encountered by the National Assembly in finalizing the appointment of the external auditors. The establishment of the Supreme Audit Institution has been delayed because the National Assembly has not yet appointed the Council that will lead this institution.**

7. Pillar III and Pillar VI evaluate PFM performance through the budget cycle from planning, preparation to execution, monitoring, evaluation and control. **The overall performance of Serbia shows that, while budget preparation processes have improved, the overall credibility of the budget is hampered by serious weaknesses in checks and balances for the budget execution, particularly the absence of orderly financial accountability through external auditing.**

8. Pillar III evaluates links between policy and budgets through the budget process**. While improvements could still be made in the budget's policy focus, recent improvements in the budget process mean that Serbia's performance on this Pillar compares favorably with other countries**. In keeping with the provisions of the Budget System Law (BSL), a budget circular (the Budget Memorandum) and an improved and clear budget calendar, which

[11] Federal government of Serbia and Montenegro.
[12] Autonomous Province of Vojvodina
[13] Namely the introduction of a comprehensive budget circular (the Budget Memorandum)

is largely followed, has been introduced. The Budget Memorandum, which has been developed in preparation for the annual budget exercise starting in 2002, contains key fiscal forecasts and sector strategies. This is an important step forward, but the next step is to build in a direct link between these strategies on the one side and actual costing of investments and recurrent costs on the other.

9. Pillar IV, Predictability and Control in Budget Execution, assesses whether the budget is implemented in an orderly and predictable manner and whether there are arrangements for the exercise of control and stewardship of the management and use of funds, including revenue and expenditure**. In Serbia, the average score for Pillar IV is close to C, pointing to weaknesses, particularly in the area of post-control over budget execution, which remains insufficient to secure integrity in the use of funds**.

10. **While tax obligations are clear and easy to meet, tax arrears are still relatively high.** Transparency and measures to protect taxpayers against arbitrary rulings could still be improved. Also, the effectiveness of measures for taxpayer registration and tax assessment is undermined by the fact that the relevant information systems are not integrated and practices are not harmonized. Despite over-performance on overall budgets for tax revenues and recent improvements in collections of tax arrears, tax arrears are still very significant based on international comparators, but the lack of information on the impact of tax arrears from state-owned companies under privatization is preventing a clear picture of the efficiency of the tax collection.

11. **Commitment ceilings are provided on a three-month rolling basis, but ceilings are not always reliable and cause delays and disturbances in the execution of this task. Better projections on the revenue side are needed to improve reliability.** In-year budget reallocations are frequent and a 5 percent reallocation limit on individual appropriations does not effectively limit the frequency or the total of reallocated amounts.

12. **The quality and frequency of debt recording and reconciliation is considered fairly good**. **However, while some controls over payroll exist and improvements are being made, they are still inadequate to ensure the full integrity of data, mainly due to lack of ex-post control through internal and external audit. Public procurement management suffers from inefficiencies due to inadequate enforcement of competitive mechanisms**. Around 70 percent of the contracts are awarded through open competition but justifications for a less competitive procurement method are weak. A complaint mechanism exists but is not yet fully operational. In line with the provisions of the Budget System Law, **financial controls of payments are carried out while appropriate procedures and practices for entering and monitoring large contractual obligations are missing.** The Ministry of Finance has established an Internal Audit Unit within the Budget Inspection and Audit Department. **While procedures, scope of work and quality of the internal audit unit seem adequate, the current very low number of internal auditors (in total 11) is seriously hampering its effectiveness.**

13. Pillar V assesses whether adequate reports and information are produced, maintained and disseminated to meet decision making, control, management and reporting purposes. **Poor scoring on Pillar V is influenced by the absence of externally audited accounts, which**

means that integrity of budget data cannot be secured despite availability and timeliness of information on budget execution. Serbia has a performing Public Payment Agency (PPA) inherited from the abolished Clearing and Settlements Bureau (ZOP). As a result, bank accounts for ministries and other Direct Budget Beneficiaries are reconciled and cleared daily, but accounts of Indirect Budget Beneficiaries (such as primary schools and health institutions) are not. Recent changes of the Budget System Law and other related legal acts will ensure that indirect budget users get the same status as all other users. Monthly and quarterly budget execution reports are submitted by Direct Budget Beneficiaries to the Ministry of Finance following a standard Chart of Accounts. While summary data per economic classification is made public, audited consolidated annual financial statements for the fiscal years 2002, 2003, 2004 and 2005 have not yet been presented to the National Assembly for approval.

14. Pillar VI assesses whether arrangements for scrutiny of public finances and follow-up by the Executive are operating. **In Serbia, external independent audit of the Government's accounts has yet to become reality**. A law on the State Audit Institution was adopted by the National Assembly in November 2005 but no decisions on appointments or other actions have yet been taken to set up a functional institution. The budget calendar and procedures allow the National Assembly enough time for a meaningful budget debate but, as discussed under Pillar II, budget documentation could be improved. With significant delay, the Government and the National Assembly have taken action to ensure that the Government's accounts for 2002, 2003, 2004 and 2005 will be subject to an independent external audit, but the auditors have not yet been formally appointed. Availability of audited financial statements in the public enterprise sector is incomplete, though major progress has been made since the start of the reforms.

15. **Scores under Pillar IV, V and VI tell a consistent story of limited accountability in the use of public funds.** The paradox is that budget execution data are readily available and efforts have been made to increase availability of data to the policy makers and the public, but mechanisms to control and account for the use of funds are deficient. A major problem is the tardiness in agreeing to the process for selection of external auditors in the interim period, while the Supreme Audit Institution is not yet fully functioning. When the use of funds cannot be ascertained through an independent evaluation, the PEFA indicators cannot help in informing as to what extent the budget supports operational efficiency or efficient implementation of programs. The limited accountability experienced and the lack of follow-up recommendations from a systematic audit process raise questions on the credibility of the budget preparation process, and allocative efficiency**.**

16. **Addressing weaknesses in Serbia's PFM management and institutions is essential to ensure a strong and dynamic private sector.** In the December 2004 Serbia Economic Memorandum, the overlap of control authorities, including on taxes, and the need for restructuring of Socially or State-Owned Enterprises (SSOEs) and ensuring audit of state-support funds were mentioned as specific burdens on the investment and business climate in Serbia. Recent changes in tax laws and the publishing of audited financial statements from SSOEs have somewhat addressed the concerns expressed in the Economic Memorandum.

17. **Assessment of donor practices under Indicators D1-D3 shows that donors may contribute to disbursement unpredictability and still largely use ring-fenced PIUs**. As PIUs are temporary in nature, they do not necessarily have robust, sustainable accounting

systems and financial control practices, but the World Bank and other donors have been unable to rely on country systems to date. Based on the limited publicly-available information, donors' funding projections appear unpredictable and this may compound weaknesses discussed under Pillar IV.

18. **Considerable challenges in PFM reforms require strategic leadership of the overall PFM reform process and stronger coordination within the Government and among development partners.** Donors have committed considerable amounts to capacity development in PFM, including in cash management, financial reporting and external auditing functions. To ensure successful PFM reform in the future, the government needs to take the lead by setting strategic directions and actively coordinating ongoing and planned support from developing partners.

19. **Recent steps in the right direction are significant and encouraging milestones**. These include making budget execution data publicly available; modernizing the Treasury and internal control system; adopting a law for the establishment of a Supreme Audit Institution; and seeking and obtaining parliamentary approval of the appointment of an external auditor for the 2002, 2003, 2004 and 2005 accounts. In addition, the Government is committed to further Public Financial Management reforms as demonstrated in ongoing reforms on, for example, introduction of program budgeting and integrated planning, budgeting, monitoring and reporting across Government as further described in Chapter 4.

Table 1. Summary of Performance Indicators

PEFA INDICATOR	PEFA SCORE
A. PFM OUTTURNS	
Pillar I. Credibility of the Budget	
PI-1: Aggregate expenditure outturn compared to original approved budget	**A**
PI-2: Composition of expenditure outturn compared to original approved budget	**C**
PI-3: Aggregate revenue outturn compared to original approved budget	**A**
PI-4: Stock and monitoring of expenditure payment arrears	**C+**
B. KEY CROSS-CUTTING ISSUES	
Pillar II. Comprehensiveness and Transparency	
PI-5: Classification of the budget	**C**
PI-6: Comprehensiveness of information included in the budget documentation	**B**
PI-7: Extent of unreported government operations	**B+**
PI-8: Transparency of intergovernmental fiscal relations	**B+**
PI-9: Oversight of aggregate fiscal risk from other public sector entities.	**C**
PI-10: Public access to key fiscal information	**B**
C. THE BUDGET CYCLE	
Pillar III. Policy based budgeting	
PI-11: Orderliness and participation in the annual budget process	**A**
PI-12: Multi-year perspective in fiscal planning, expenditure policy and budgeting	**C**
Pillar IV. Predictability and control	
PI-13: Transparency of taxpayer obligations and liabilities	**B**
PI-14: Effectiveness of measures for taxpayer registration and tax assessment	**B**
PI-15: Effectiveness in collection of tax payments	**D+**
PI-16: Predictability in the availability of funds for commitment of expenditures	**C+**
PI-17: Recording and management of cash balances, debt and guarantees.	**B**
PI-18: Effectiveness of payroll controls	**C+**
PI-19: Competition, value-for-money and controls in procurement	**C+**
PI-20: Effectiveness of internal controls for non-salary expenditure	**C**
PI-21: Effectiveness of internal audit	**C+**
Pillar V. Accounting, recording and reporting	
PI-22. Timeliness and regularity of accounts reconciliation	**B+**

PEFA INDICATOR	PEFA SCORE
PI-23: Availability of information on resources received by service delivery units.	**B**
PI-24: Quality and timeliness of in-year budget reports	**B+**
PI-25: Timeliness of the presentation of audited financial statements to the legislature.	**D**
Pillar VI. External scrutiny and audit	
PI-26: Scope, nature and follow-up of external audit.	**D**
PI-27: Legislative scrutiny of the annual budget law	**C+**
PI-28: Legislative scrutiny of external audit reports.	**D**
Assessment of Donor Practices	
DI-1: Predictability of Direct Budget Support	**D**
DI-2: Financial information provided by donors for budgeting and reporting on project and program aid	**D+**
DI-3: Proportion of aid that is managed by use of national procedures	**D**

CHAPTER 1: INTRODUCTION

Conceptual Framework for the PFM Assessment

1. It is widely recognized that effective institutions and systems of public financial management (PFM) have a critical role to play in supporting implementation of policies of national development and poverty reduction. The PEFA/PFM Performance Measurement Framework has been developed as a contribution to the collective efforts of government, donors and other stakeholders to assess and develop essential PFM systems by providing a shared information pool for measurement and monitoring of PFM performance and a common platform for dialogue.

2. The PFM Performance Measurement Framework is an integrated monitoring framework that allows measurement of country PFM performance over time. It has been developed through a concerted international effort by PEFA partners in collaboration with the OECD/DAC Joint Venture on PFM.[14] The framework incorporates a set of high-level indicators, which draw on HIPC[15] expenditure- tracking benchmarks, the IMF Fiscal Transparency Code and other international standards, and a PFM Performance Report that provides information on PFM performance as measured by the indicators. The PFM Performance Report recognizes efforts by government to reform its PFM system by describing recent and ongoing reform measures, which may or may not have impacted on PFM performance.

3. Against six core dimensions of PFM performance, the high-level indicators measure the operational performance of the key elements of the PFM systems, processes and institutions of a country central government, legislature and external audit. Following an assessment, the individual indicators are assigned a score of "A", "B", "C" or D, with "A" assigned to the highest performance and "D" to the lowest performance.[16] The Performance Measurement Framework identifies the six critical dimensions of performance of an open and orderly PFM system as follows[17]:

I. **Credibility of the budget** - The budget is realistic and implemented as intended.

II. **Comprehensiveness and transparency** - The budget and fiscal risk oversight are comprehensive and fiscal and budget information is accessible to the public.

[14] PEFA (Public Expenditure and Financial Accountability) is a multi-agency partnership program sponsored by the World Bank, the IMF, the European Commission, the UK's Department for International Development, the French Ministry of Foreign Affairs, the Royal Norwegian Ministry of Foreign Affairs, the Swiss State Secretariat for Economic Affairs, and the SPA Strategic Partnership for Africa.
[15] Heavily Indebted Poor Countries.
[16] As mentioned previously, scores are assigned using the methodology described in Annex I. The full methodology for measurement of the PEFA indicators is available from the PEFA website: http://www.pefa.org/about_test.htm
[17] These core dimensions have been determined on the basis of what is both desirable and feasible to measure and define the nature and quality of the key elements of a PFM system captured by the set of high-level indicators.

III. **Policy-based budgeting** - The budget is prepared with due regard to government policy.

IV. **Predictability and control in budget execution** - The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.

V. **Accounting, recording and reporting** – Adequate records and information are produced, maintained and disseminated to meet decision-making control, management and reporting purposes.

VI. **External scrutiny and audit** - Arrangements for scrutiny of public finances and follow up by executive are operating.

4. The Performance Measurement Framework also uses the indicator analysis to evaluate the likely impact of PFM weaknesses on the three levels of budgetary outcomes: aggregate fiscal discipline, strategic allocation of resources, and efficiency of service delivery.[18]

5. The main focus of the PFM indicator set is on PFM performance at central government level, including the related central institutions of oversight. The framework does not measure factors impacting on performance (such as capacity of institutions or the legal framework) nor does it involve fiscal or expenditure policy analysis. This would require detailed country-specific data analysis. Instead, the framework focuses on the extent to which the PFM system is an enabling factor for the achievement of policy outcomes. The selected indicators are structured into three categories:

A. **PFM system outturns**: these capture the immediate results of the PFM system in terms of actual deficit, expenditures composition and revenues by comparing them to the original approved budget.

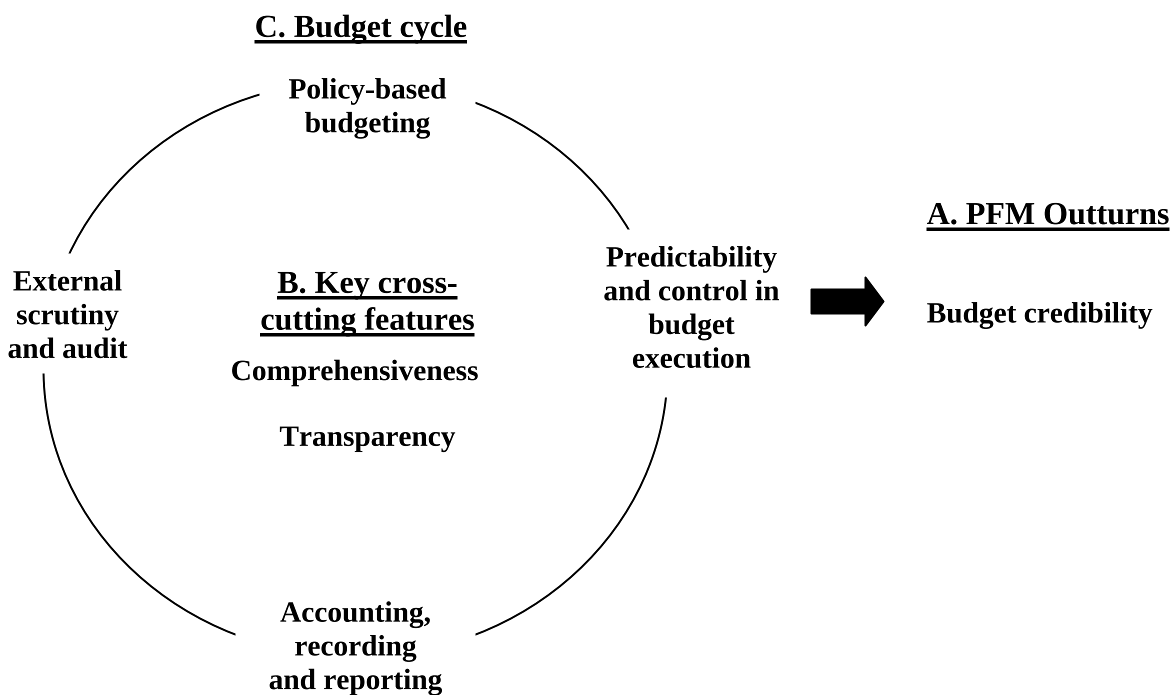
B. **Cross-cutting features of the PFM system**: these capture the comprehensiveness and transparency of the PFM system across the whole of the budget cycle.

C. **Budget cycle**: these capture the performance of the key systems, processes and institutions within the budget cycle of the central government.

The diagram in *Figure 2* below illustrates the structure and coverage of the PFM system measured by a set of high-level indicators and links with the six core dimensions of a PFM system:

[18] These core dimensions have been determined on the basis of what is both desirable and feasible to measure and define the nature and quality of the key elements of a PFM system captured by the set of high-level indicators.

Figure 2. Core dimensions in Public Financial Management (PFM) system



CHAPTER 2: COUNTRY BACKGROUND

Country Political Situation

6. **Under the 2003 Constitutional Charter, the two Republics of the former State Union of Serbia and Montenegro (SAM) were required to fund the institutions and activities of the Union.** The total expenditures in the budget for the Republic of Serbia were RSD 416.6 billion in 2005, of which the contribution to SAM totaled RSD 49.9 billion. The grant to SAM is clearly identified in the Serbian budget, and expenditures are broken down per economic and administrative classification.

7. **In light of the aspirations of the Republic of Serbia for membership of the European Union, the Stability and Association Agreement together with the Poverty reduction Strategy constitute a strategic framework for the Government's policies.** While not officially a European Union (EU) candidate country, Serbia's political cooperation and *rapprochement* with the EU is defined via the Stabilization and Association Process (SAP). The SAP was confirmed at the Thessaloniki European Council summit in June 2003 as the EU's policy framework for South Eastern Europe for accession to the EU. In it's April 12, 2005 communication the European Commission concluded that it considered Serbia and Montenegro sufficiently prepared to negotiate the SAA and that it recommended that the Council [of EU ministers] open the negotiations. The Poverty Reduction Strategy (PRS) is a broad social and economic development strategy that was drafted based on a broad government lead consultative process. The PRS progress report was submitted to the World Bank and the IMF in October 2005 and the positive joint IDA-IMF staff advisory note was issued on February 16, 2006.

8. **Recent political events make the political situation volatile.** The political agenda is dominated by highly sensitive issues such as the negotiations of the future status of Kosovo, Montenegro's recent independence and events related to Serbia's cooperation with the International Criminal Tribunal for the Former Yugoslavia (ICTY).

Country Economic Situation

9. **Growth in Serbia has been sustained but volatile since 2002 (2.4 percent, 9.3 percent and 4.8 percent in 2003, 2004 and 2005 respectively).** It has been fed by strong domestic demand, and has led to maintaining large current account deficits[19] (from 8.9 percent of GDP in 2002 to an estimated 12.5 percent in 2004 and an estimated 8.8 percent in 2005), despite tightening of fiscal policies. Overall fiscal balance on a cash basis for Serbia and Montenegro increased from 4.5 percent in 2002 to an estimated 0.4 percent in 2005. The Serbia Republican government overall balance (before grants) also improved from -4.5 percent in 2002 to an estimated 0.8 percent in 2005. Also fueled by strong demand and external shocks, inflation has remained high in Serbia during the same period and is estimated at 17.7 percent in 2005 (end of period). While FDI and grants have largely financed the current account deficit, the challenge will be to reduce Serbia's external vulnerability by sustainable shrinking of the current account deficit. In the

[19] For Serbia and Montenegro.

future, the need to increase domestic savings will warrant further fiscal tightening (overall fiscal balance before grants of the Serbian Republic is projected at 1.9 percent of GDP in 2006). Continued fiscal tightening highlights the importance of qualitative fiscal adjustments in the Serbian budget, a significant challenge in the coming years (see below).

10. **The Serbian government has made significant progress in implementing its economic program, although structural reforms required in the second stage of the program have been relatively slow.** On the structural front, as mentioned in the 2005 update of the Public Expenditure and Institutional Review[20], Serbia has made important strides in implementing the initial stage of its economic program, which focused on stabilizing the economy, carrying out first generation reforms—that is, price and foreign exchange liberalization—laying the foundations for second generation reforms and urgent reconstruction. Indeed, according to the recent World Bank Country Policy and Institutional Assessment (CPIA) and Doing Business 2005, Serbia has made significant progress in tackling structural problems and in establishing a more conducive environment for private sector- driven economic growth and in this respect ranked first in the effectiveness of reforms in 2004. However, progress in the second stage of the program involving structural reforms necessary to ensure long-term economic stability and sustainable growth has been relatively slow: the implementation pace of reforming public finances, encouraging private sector growth, and addressing the structural problems of the enterprise sector should be accelerated.

11. **Slow progress in the noted structural reforms and policy slippages, in turn, put some of the earlier achievements at risk, as evidenced by widening macroeconomic imbalances and the rekindling of inflationary pressures.** The authorities have further tightened the fiscal policy stance beyond program targets to respond to the noted adverse developments. As evidenced by the data in *Table 2* below, fiscal adjustments to date have relied somewhat on modest increases in revenues but mostly on reductions in spending[21]. In order for the current policy stance to be sustainable, the underlying structural causes of the large current account deficit and high public expenditures need to be addressed.

[20] The Republic of Serbia: A Policy Agenda for a Smaller and More Efficient Public Sector (Draft of December 1, 2005).
[21] Total revenues (excluding grants) were increased from 24.7 percent of GDP in 2002 to an estimated 25.4 percent of GDP in 2005, whereas expenditures were reduced from 29.1 percent of GDP in 2002 to 24.7 percent of GDP in 2005.

Table 2. Fiscal performance 2003-2005

	Republican fiscal operations				General Government fiscal operations[22]		
	As percentage GDP[23]				As percentage GDP		
Fiscal Year	**2002**	**2003**	**2004 est.**	**2005 proj.**	**2003**	**2004 est.**	**2005 proj.**
Total expenditure and net lending	**29.1**	**27.2**	**25.9**	**24.7**	**43.0**	**42.3**	**40.2**
1.Total expenditure	29.0	26.6	25.9	24.5			
2. Current expenditure	27.1	24.5	23.6	22.9	40.0	39.6	37.4
2.1. Expenditure on goods and Services	5.9	7.4	6.9	7.3	17.5	17.6	16.7
2.1.1. Wage-bill related	4.3	5.5	5.0	5.1	9.5	9.5	9.8
2.1.2 Other purchases of goods and services	1.5	1.7	1.7	1.9	8.0	8.1	6.9
2.2. Interest payments	0.7	0.9	1.0	1.0	0.9	1.3	1.4
2.3 Subsidies and transfers	20.6	16.2	15.6	14.6	21.6	20.7	19.3
2.3.1. Subsidies	3.4	2.6	2.5	1.6			
2.3.2. Transfers to households	3.2	3.1	2.3	2.7			
2.3.3. Transfers to other levels of government	14.0	10.4	10.8	10.3			
3. Capital Expenditure	1.9	1.8	2.2	1.6	2.4	2.6	2.5
4. Lending minus repayment	0.1	0.6	0.1	0.3	0.6	0.1	0.3
Total Revenues excl. grants	**24.7**	**24.2**	**25.0**	**25.4**	**39.9**	**42.3**	**41.3**
Overall balance excluding grants	**-4.5**	**-2.8**	**-0.9**	**0.7**	**-2.9**	**0**	**1.1**
Public sector debt					**79.2**	**67.3**	**52.1**

Source: IMF, Serbia and Montenegro: Sixth Review Under the Extended Arrangement, Financing Assurances Review, Request for Waivers of Non-observance of Performance Criteria, and Proposed Post-Program Monitoring, January 2006.

12. **Fiscal adjustments have gradually improved fiscal outcomes but the quality of adjustments remains an issue**. The current account deficit is still high, reaching an estimated 10.8 percent in 2005. Expenditure reduction has been born by: (i) reduction in transfers to households; (ii) under-spending in goods and services; and (iii) maintaining capital spending at low levels. Subsidies to public enterprises also declined as a result of reforms in the sector (although more effort is needed to carry through the restructuring/privatization agenda). The wage bill has been largely preserved.

Legal Framework

13. **The Budget System Law (Official Gazette of the Republic of Serbia (OG) No. 9/2002 and No. 87/2002) provides a sound, general legal framework for PFM.**

[22] Includes the state union, Republican and local governments, social security funds and extra-budgetary programs in Serbia.
[23] Compared to GDP of the State Union of Serbia and Montenegro.

Specifically, the BSL provides a legal framework for the following, essential aspects of PFM:

- The introduction of a comprehensive budget memorandum setting out the preconditions and general policy guidelines for the annual budget.
- A new budget calendar and detailed procedures for budget preparation.
- Planning, preparation and enacting of the budgets of local government[24] into the budget process of general government.
- Streamlining of the budgeting process for main Extra-Budgetary Funds (EBFs)[25] in line with the general government budget processes, applying similar budgeting, accounting, and control and oversight mechanisms as for Direct Budget Beneficiaries (DBB).
- An estimate of the total amount of new borrowing and a summary of anticipated proceeds from foreign and domestic borrowing in the revenues for the general part of the consolidated budget.
- Inclusion and identification of donor contributions to individual DBBs in the budget breakdown[26].
- The creation and operation of a Treasury Single Account (TSA) in which all cash assets of the Republican budget and the main EBFs must be deposited[27].
- The application of a single, standard budget classification, including an economic, organizational, functional and “accounting fund classification”[28].
- A calendar and assignment of responsibilities for the preparation and submission of final and audited government accounts statements[29].

[24] Local governments comprise “territorial autonomies” and “local authorities”. The “territorial autonomies” are Vojvodina and Kosovo, while “local authorities” consists of 191 municipalities of which 118 are outside Vojvodina and Kosovo.

[25] This includes the: (i) Republic Health Insurance Institute; (ii) Republic Pension and Disability Insurance Funds (including the Farmers’ Pension and Disability Fund); and (iii) Republic Labor Market Office; and (iv) Pension fund for self-employed. These are referred to in the BSL as the “mandatory social security organizations”.

[26] The Law on the Budget of the Republic of Serbia 2005 contains an annex with detailed breakdown of budgets of DBBs, The economic classification distinguishes between revenue sources such as “Donations from international organizations” (06); Donations from NGOs and Individuals (08) etc.

[27] Article 8 of the BSL. For one of the most significant EBFs, the Health Insurance Fund, once funds allocated in the budget are transferred to the Treasury sub-account of the central office of the Health Insurance Fund, funds are no longer controlled by the Treasury and payments are authorized by the Health Insurance Fund and disbursed through bank accounts of individual branch offices of which there are 32 (including 4 non-operating branches in Kosovo).

[28] Article 11 of the BSL does not refer to the more commonly used term “programmatic” classification but uses the term “accounting fund classification”, which it defines as the classification that “identifies receipts and outflows pursuant to requirements for carrying out specific activities or for attaining certain objectives, in accordance with special regulations (separate identification of funds obtained from international agreements, funds from additional postal stamps for particular humanitarian purposes, etc).”

[30] Article 61 and Articles 62-65 of the BSL

- The obligation for the MOF to regulate the method of budget accounting and financial reporting.[30]
- Assigning the responsibility for legal, correct, economic and effective use of budgetary appropriations to the Head of the DBB, while granting him/her the right of delegation.[31]
- Assigning the responsibility for the establishment of sound financial services and internal control systems to DBBs and Indirect Budget Beneficiaries (IBBs).[32]
- The segregation of authorizing, accounting and financial control functions.[33]
- The establishment of a central, government-wide Inspection and Audit Service at the Ministry of Finance.[34]
- The requirement for an external audit of the "annual account statement of the Republic, local authority and financial plans of mandatory social security organizations" as well a mandate to temporarily appoint a suitably qualified external auditor until a Supreme Audit Institution has been established.[35]

14. **A comprehensive set of detailed laws and regulations regulate public sector accounting, financial reporting, procurement, cash management, internal and external auditing and the prevention of conflict of interest.** This includes the Decree on Budget Accounting (OG No. 125/2003); the Bylaw on Standard Classification Scope and Account (OG No. 92/2002) and the Rules on the Manner in which Resources in Sub-Accounts and/or Other Accounts of the Treasury Single Account of the Republic Shall be Used (regulation No. 110-00-292/2003/06). Internal audit and budget inspection activities are regulated through the Decree on the Method of Operation and Authorities of Budget Inspection and Audit (OG No. 10/2004). A Public Procurement Law (PPL) entered into force on July 13, 2002. It is in line with EU procurement regulations but needs some revisions to provide a firmer basis for transparency, accountability and competitiveness. The Law on Alterations and Amendments to the PPL entered into force on July 1, 2004. It streamlined procurement procedures and defined protection of tender's right more precisely. The PPL was altered to allow for publication of all contract awards, allowed award of contract below a threshold, even if only one tender (which was correct, adequate and acceptable) was received. Also the status, composition and functioning of the Commission for the Protection of Tenderers' Rights (CPTR) was better defined in the modifications. Whereas the BSL provides a basis for contracting an external auditor to audit the consolidated budget of the Republic, the National Assembly passed a Law on the State Audit Institution on November 14, 2005. A Law on Prevention of Conflict of Interest in Discharge of Public Office (OG No. 43/2004) provides a legal basis for fighting official corruption. In support of the Government's anti-corruption efforts a revised Law on the Prevention of Money-Laundering was passed by the National Assembly on December 30, 2005.

[30] Article 62 of the BSL.
[31] Article 50 of the BSL.
[32] Articles 9 and 66 of the BSL.
[33] Article 51 of the BSL.
[34] Articles 67-70 of the BSL.
[35] Articles 71 and 80 of the BSL.

Institutional features and framework

15. **The central administration of the Republic comprises some 72 ministries and other central government bodies, which are the Direct Budget Beneficiaries (DBB). In total there are some 9,000 budget beneficiaries of which most are second tier Indirect Budget Beneficiaries (IBB).** IBBs include primary schools and health care institutions. In addition to this there are 130 local government administrations and five mandatory Social Security Organizations. The public sector of the Republic comprises a total of 416,103 (2004) staff. Health care and Education are by far the largest sectors, employing 164,743 and 131,101 staff (2004) and constituting 6.9 percent and 3.7 percent of GDP respectively (2004)[36].

16. **The Minister of Finance oversees the implementation of the Budget System Law, which regulates budget execution, debt management, budget accounting and reporting through the establishment of the Treasury.** The Ministry of Finance comprises 11 "sectors" or units/departments and supervises seven "administrations", including the Tax Administration, the Treasury, the Administration for the Prevention of Money Laundering (APML), the Customs Administration, the Gaming Administration and the Administration of Public Debt (still to be established).

17. **The administrative capacity in terms of number of skilled staff in the government administration, including key departments of the MOF, continues to be low.[37]** This includes the administrative capacity of the MOF's Cash and Debt Management units and Macroeconomic and Fiscal Analyses Department. The same goes for the financial services and internal audit units in the line ministries and DBBs. Whereas the Law on a State Audit Institution has been adopted, the first steps to actually establish and staff the institution are still to be taken. It is essential to build capacity for effective horizontal co-operation within MOF to succeed with the challenging PFM reforms. This could partly be achieved through the strengthening of the coordination role of the State Secretary and the Modernization Council of the MOF.

18. **A key feature of the Serbia PFM system is the infrastructure of the abolished Clearing and Settlements Bureau (ZOP) of ex-Yugoslavia which today, as the Public Payment Agency, is an integral part of the Treasury system.** The ZOP system handled all payments in ex-Yugoslavia, including transactions of local and central government and private individuals and businesses. Although the system in its original form has now been abolished and no longer covers transactions in the private sector, a part of the system, the Public Payment Agency (PPA), today constitutes the backbone of the Government's treasury system. Today the PPA is an integral part of the Treasury, executes payments and maintains a registry and accounts for some 9,000 Budget Beneficiaries. PPA maintains the TSA and some 200 sub-accounts in the National Bank

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[36] The source for the staff numbers is the draft PEIR update of December 2005, table 23, p. 23, which refer to the Republican Statistical Office as its source. Budget numbers come from the Memorandum of the Budget 2006, table 11, p. 34)

[37] The total number of staff in the MOF's central offices is very modest. In its report: Balkans Public Administrative Reform Assessment: Serbia and Montenegro, May 26, 2004, SIGMA reported that the central functions of the Ministry of Finance and Economy (including the Budget and central Treasury departments (not including the PPA)) had less than 65 staff.

of Serbia (NBS) and executes payments including electronic transactions on behalf of the Government. This includes payments for the DBBs covered by the Interim Treasury Ledger System (ITLS), which ensures ex-ante authorization of payment requests from DBBs, including approved payment requests from IBBs. The PPA shares 30 of its 34 branch offices and 111 sub-branch offices with the NBS and has a staff of some 1,000 people.

19. **The institutional framework for public procurement in Serbia has been completed but the development of appropriate practices are still under way**. The system of public procurement in Serbia rests on three pillars: the Ministry of Finance and Economy, the PPO and the CPTR. The PPO began operating on January 15, 2003. The PPO was set up according to the Law as an independent agency of the Government of Serbia assigned with establishing an economic, efficient and transparent system of public procurement. The functioning of the CPTR Committee is closely regulated by its Operational Procedures, which contains issues not covered by the PPL. These are treatment of requests, case allocation, decision-making, record maintaining and filing. These Procedures were published on July 27, 2004. Lack of stability in the work of the CPTR has been caused, among other factors, by the fact that its members are easily appointed, and dismissed by the Government. The procurement institutional framework needs to be complemented by the introduction of external audits that will include procurement audits.

CHAPTER 3: PUBLIC FINANCIAL MANAGEMENT PERFORMANCE INDICATORS

A. PROGRESS SINCE 2002 WORLD BANK ASSESSMENTS AND OVERVIEW OF PFM PERFORMANCE

20. **Since the 2002 Country Financial Accountability Assessment (CFAA) and the 2002 Country Procurement Assessment Report (CPAR), the legal and institutional framework for PFM has improved in a number of areas**. This followed the adoption of a Budget System Law (BSL) and an improved Public Procurement Law (PPL) in 2002. In the wake of the new legislation, new administrative entities were created and budget management processes were developed. Part A of Annex IV provides an overview of the status of implementation of the 2002 CFAA recommendations.

21. **New administrative entities for budget analysis, treasury management (including cash and debt management and accounting policies), financial control, internal audit and procurement have been established**. Visible progress has been made in consolidating the budget and establishing and institutionalizing commitment and payment controls. A Public Procurement Office (PPO) which issued secondary procurement legislation and standard procedures has been established and a Commission for the Protection of Tenderers' Rights (CPTR) was created. Another institution, the Administration for the Prevention of Money Laundering has, in concrete cases, proven its ability to investigate and initiate prosecution of high-profile money laundering cases. Similarly, the Anti-Corruption Council has been an active promoter of greater transparency in public finance. Meanwhile, it appears that the cooperation between the Council and the Government thus far has not been optimal and that the Government has prepared a law which will establish a new anti-corruption body.

22. **Whereas many recommendations of the 2002 CFAA have been implemented, some of the most fundamental ones, related to external accountability, have not.** This is the case in particular for financial reporting and external oversight, both basic foundations of fiscal transparency and accountability. Specifically, public accounts for 2002, 2003, 2004 and 2005 have not yet been submitted to Parliament and the law for the creation of a Supreme Audit Institution was only adopted in November of 2005. Moreover, contrary to the provisions of the 2002 BSL no external auditor was appointed in the interim.

23. **Despite considerable progress since the 2002 CPAR, procurement legislation and institutions still require consolidation.** Further improvements are needed in legislative framework, overall business environment and in the process for decision making for projects, as already underlined in the 2002 CPAR. However, the main challenge today is strengthening the procurement institutions and enforcing PPL implementation at all levels, including improving budgeting for procurement and particularly procurement planning. Part B of Annex IV provides an overview of the status of implementation of the 2002 CPAR recommendations

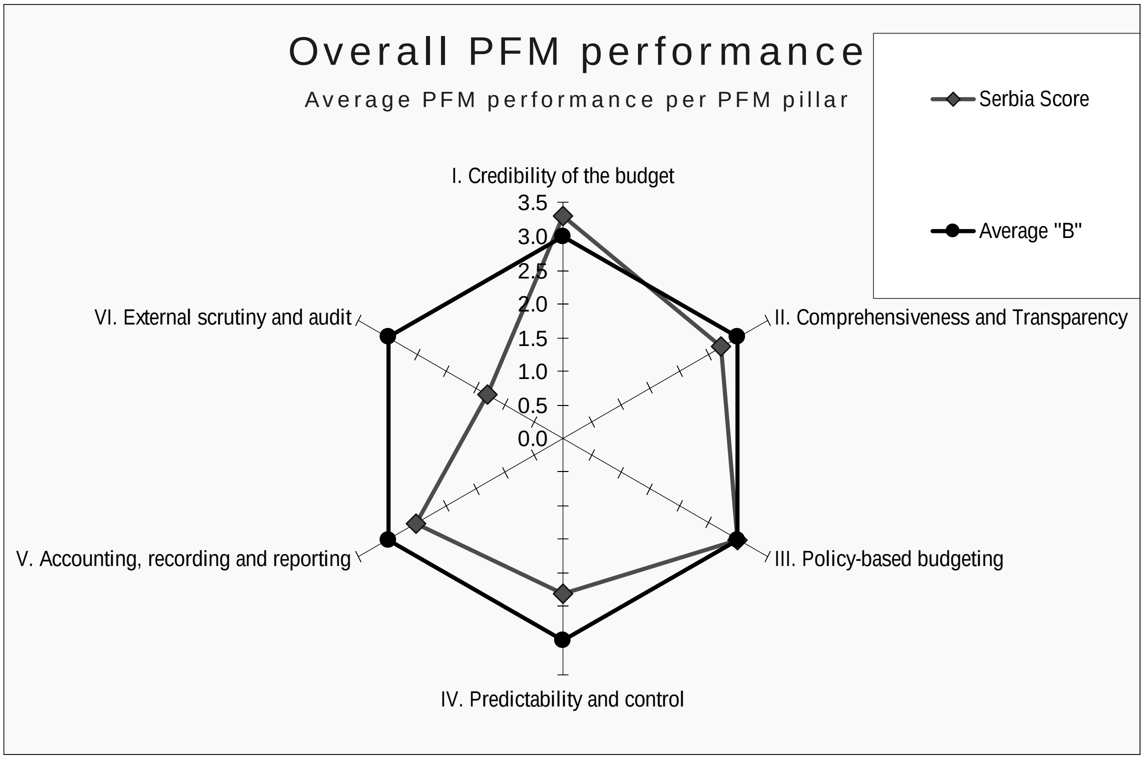
24. **Overall PFM performance, as measured by the indicators grouped under the above six pillars for Serbia, is mixed and confirms the above update**. On the positive

side, *Figure 1* shows that the budget preparation process supports the use of the budget as a policy tool (Pillar III). In that area, Serbia has reached an adequate performance level. While appropriate caution is needed in assessing credibility, comprehensiveness, and transparency of the budget (Pillar I and II) due to lack of independent assurance of data, the available data tentatively points to improved reliability of the budget. On the negative side, *Figure 1* clearly shows that accountability, the corner principles of good PFM, is weak, as shown by low performance under Pillars IV, V and VI.

25. **In comparison with a desirable "B" rating, Serbia's Public Financial Management performance clearly shows the weak areas.** As *Figure 1* below shows, Serbia's performance is, for three out of six dimensions, well below the desirable rating that EU-aspiring countries should strive to achieve.[38]

[38] While between 15 and 20 PEFA assessments have been carried out in countries across the world so far, no PEFA assessment exists for EU countries or EU candidates. It is, however, reasonable to assume that scores for EU members rate an average of B or above.

Figure 1. Compared PFM Performance[39]



B. PFM OUTTURN: Credibility of the Budget

PI-1: Aggregate expenditure outturn compared to original approved budget

Dimension to be assessed: the difference between actual primary expenditure and the originally budgeted primary expenditure (i.e. excluding debt service and externally-financed project expenditure.

26. **Considering the fact that the consolidated accounts for the Republic have not been presented to the National Assembly nor audited for the last four fiscal years (2002-2005), the reliability of the available data is considered uncertain.** However, based on the still unaudited financial statements provided to the team by MOF, data presented in *Table 3* below, point tentatively towards reduced variance between budgets and outturns for the Republican budget. Between 2003 and 2005, total outturns as a percentage of budgets have decreased, showing increased reliability of expenditure budgets. Variance decreased from 6 percent in 2003 to 4 percent in 2005. In only one out of the past three years (namely 2003), expenditure outturns deviated from the budgeted expenditure by more than 5 percent. In accordance with the PEFA scoring methodology, the score for this indicator is therefore set at A.

[39] Please refer to footnote 8 for details on the calculation of the ratings for each pillar.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-1: Aggregate expenditure outturn compared to original approved budget.	While the reliability of available data is uncertain, the budget deviations observed for the period 2003 to 2005 suggest that the annual expenditure budgets are increasingly credible.	**A**

Table 3. Expenditure outturns for central government of Serbia, 2003-2005

	2003			**2004**			**2005**		
EXPENDITURES in Billion RSD									
	Budget	**Actual**	**Difference**	**Budget**	**Actual**	**Difference**	**Budget**	**Actual**	**Difference**
1.1. Personnel Expenditure	56.4	59.3	-2.9	74.7	81.8	-7.1	91.8	94.2	-2.4
1.2. Goods and Services	29.4	24.1	5.3	33.9	37.2	-3.3	41.5	48.6	-7.1
1.3. Interest Payment	11.0	11.0	0	14.1	14.1	0.0	22.3	17.3	5.0
1.4. Subsidies	49.2	30.8	18.4	41.3	35.1	6.2	32.9	29.5	3.4
1.5. Social Protection Payments	32.1	32.2	-0.1	33.8	32.9	0.9	43.2	43.2	0.0
1.6. Other expenditures	8.0	4.4	3.6	11.7	4.7	7.0	5.2	5.5	-0.3
2. Current transfers	79.2	120.5	-41.3	147.4	150.7	-3.3	167.2	185.2	-18.0
3. Capital Outlays	16.8	16.6	0.2	39.7	29.2	10.5	41.5	33.6	7.9
Total Billion RSD (ex. interest payment)	271.1	287.9	-16.8	382.5	371.6	10.9	423.3	439.8	-16.5
Variance total in percentages			-6.2%			2.8%			-3.9%

Source: The Law on the Budget of Republic of Serbia 2003, 2004, 2005 (Budget) and unpublished Annual Financial Statements for 2003, 2004, 2005, Ministry of Finance.

PI-2: Composition of expenditure outturn compared to original approved budget

Dimension to be assessed: Extent to which variance in primary expenditure composition exceeds overall deviation in primary expenditure (as defined in PI-1) during the last 3 years.

27. **Data according to administrative classification show a sharp decrease in variation from 2003 to 2005** When the composition of expenditure varies considerably from the original budget, the budget will not be a useful statement of policy intent. As an administrative level composition is preferred by PEFA guidance and is available in Serbia, the assessment is based on the administrative composition (ministries/agencies).

28. Expenditure deviation across the budgetary heads shows that the absolute value of the deviations as a percentage of total primary expenditure was as follows: 24.0 percent

in 2003, 9.0 percent in 2004, and 7.9 percent in 2005. Deducting these percentages from the overall primary expenditure deviation for each year (shown in indicator 1), as required by the PEFA methodology, provides the following absolute measures by which variances in expenditure composition exceeded overall expenditure variance: 2003 – 17.8 percent, 2004 – 6.2 percent, 2005 – 4.0 percent (see *Table 4)*. The degree of deviation has declined drastically over the three years. The variance in 2003 was influenced by the political conditions during the preparation of the budget due to the Presidential elections in December 2002, as well as the formation of the Union between Serbia and Montenegro in early 2003. In accordance with the PEFA scoring methodology the score for this indicator is set at **C**.

Table 4. Composition of expenditures

	for PI-1		for PI-2
Year	total exp. deviation	Total exp. variance	variance in excess of total deviation
2003	6.2	24.0	17.8
2004	2.8	9.0	6.2
2005	3.9	7.9	4.0

Source: The Law on the Budget of Republic of Serbia 2003, 2004, 2005 (Budget) and unpublished Annual Financial Statements for 2003, 2004, 2005, Ministry of Finance.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-2: Composition of expenditure outturn compared to original approved budget	Variance in expenditure composition exceeded overall deviation in primary expenditure by 10 percentage points in no more than one of the last three years.	**C**

PI-3: Aggregate revenue outturn compared to original approved budget

Dimension to be assessed: actual domestic revenue collection compared to domestic revenue estimates in the original approved budget.

Table 5. Aggregate revenue outturn 2003-2005

REVENUES in Billion RSD	2003			2004			2005		
	Budget	Actual	Out-turn	Budget	Actual	Out-turn	Budget	Actual	Out-turn
Revenues from budget, thereof:	*214.6*	*262.0*	***122.1***	*329.3*	*334.3*	***101.5***	*396.1*	*418.5*	***105.6***
1. Tax revenues	195.5	245.8		297.5	310.7		362.3	390.1	
1.1 Profit and Gains Tax	54.4	57.0		60.2	61.3		55.7	60.0	
1.3. VAT and Excise Tax	137.3	159.7		191.2	202.8		262.1	287.2	
1.4. Customs		23.3		33.0	34.3		39.2	39.0	
1.5. Other Tax Revenues	3.8	5.8		13.1	12.3		5.3	3.9	
2. Non-tax revenues[40]	19.1	15.8		31.9	22.8		33.8	27.5	
3. Capital Income		0.2			0.03			0.8	
4. Donations					0.8				
5. Transfers		0.1			0.1				

Source: The Law on the Budget of Republic of Serbia 2003, 2004, 2005 and “Public Finance Bulletin” December 2005, Ministry of Finance, p. 14-15.

29. **Based on the available data presented in *Table 5*, revenue budgets appear increasingly realistic**. Revenue performed consistently better than budgets largely explained by better-than-anticipated proceeds from the newly introduced VAT. In accordance with the PEFA scoring methodology, the score for this indicator is therefore set at **A**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-3: Aggregate revenue outturn compared to original approved budget	The available data shows that actual collected revenue has exceeded the budgeted revenue for the last three fiscal years, but seems to become more realistic in later years.	**A**

[40] Excluding interest revenues (number 7411 in the economic classification): RSD 374.8 million (2003); RSD 670.5 million (2004); RSD 962.9 million (2005)).

PI-4: Stock and monitoring of expenditure payment arrears

Dimension to be assessed: (i) stock of expenditure payment arrears (as a percentage of actual total expenditure for the corresponding fiscal year) and any recent change in the stock; and (ii) availability of data for monitoring the stock of expenditure payment arrears.

30. **The stock of expenditure arrears for general government is significant,** as is presented in *Table 6* below. If adding public enterprise arrears estimated at 1.6 percent of GDP in 2004, total public sector expenditure arrears would hover around 5-6 percent of GDP. **At such levels, arrears can seriously undermine the credibility of public sector financial management with adverse consequences on the economy.**

Table 6: Variation of stock of arrears of central and general governments

In billion RSD	end 2003	end 2004	end 2005	Sep-06	Difference 2005/2004
EXPENDITURE ARREARS	60.7	67.7	70.9	73.9	3.2
Republican unspecified expenditure	15.4	14.5	22.3	31.1	7.8
pension arrears	33.9	40.6	37.0	33.0	-3.6
other MSSO arrears	11.4	12.6	11.6	9.8	-1.0
Arrears as of gen. gov. exp.	12.5	11.7	10.6	8.9	
Arrears as percent of GDP	5.2	4.7	4.1	3.4	

Source: MOF, IMF

31. **At the level of the Republican budget, arrears amounted to 4 percent of the budget in 2005.** The largest arrears are generated by the following institutions: (i) Road Directorate (RSD 5.0 billion); (ii) Directorate for Commodity Reserves (RSD 2.8 billion); (iii) Ministry of Labor, Employment and Social Policy (RSD 2.7 billion); and (iv) Refugee Commissariat (RSD 2.5 billion). While no information is available about the nature of these arrears, it is noteworthy that these institutions include those who typically manage a lot of state property and large investment and maintenance contracts. This is particularly true in the case of the Road Directorate and the Directorate of Commodity Reserves.

32. **For the entire General Government, including the major EBFs, expenditure arrears were significantly higher, at an estimated RSD 70.9 billion or 10.6 percent of total General Government expenditures in 2005, but arrears have declined to just below 10 percent in 2006**. Both in relation to GDP and general expenditure, arrears have decreased substantially since 2003. In absolute terms, total expenditure arrears at end 2005 are still above their 2003 levels. However, it is noteworthy that the government brought down pension arrears (more than 75 percent of total expenditure arrears) by 10 percent in 2005. Arrears within the pension insurance systems were accumulated during the 1990s due to lack of funds and overall mismanagement. Since the beginning of transition, the Serbian government made partial payment of arrears together with regular payment of pensions and importantly a recent conversion of arrears into public debt which will be repaid in six equal tranches until mid-2008. Pensions are now paid regularly. A new initiative was launched in October 2006 to ensure decreasing arrears.

33. The significant level of arrears in relation to general expenditure, as well the marginal decline in value since 2004, warrant a **score - C on dimension (i).** The Government monitors the stock of expenditure arrears, at least on an annual basis, although data for identified expenditure categories and specified budget institutions appear to be incomplete[41] (**dimension (ii) score - B**). The overall score for this indicator is set at **C+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-4: Stock and monitoring of expenditure payment arrears	The stock of expenditure arrears is significant and, despite a recent reduction in pension arrears, the total stock of arrears has not been reduced significantly during the last two fiscal years. Arrears are currently being monitored on a regular basis.	**C+**

C. KEY CROSSCUTTING ISSUES: Budget Comprehensiveness and transparency

PI-5: Classification of the budget

Dimension to be assessed: the classification system used for formulation, execution and reporting of the central government's budget.

34. **The Republic of Serbia's budgets for 2005 and 2006 have not yet been presented using functional classification (reflecting the Classification of the Function of Government (COFOG)**). The budgets were presented as per economic and administrative classifications. However the MOF can produce data as per functional classification, and in the budget memorandum of 2006, the budget projections for 2006-2008 are presented as per functional classification. The score for the indicator is on this basis set at **C**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-5: Classification of the budget	The classification used in the budget presented to the National Assembly has not yet included a functional classification.	**C**

PI-6: Comprehensiveness of information included in the budget documentation

Dimensions to be assessed: information listed in the budget documentation most recently issued by the central government.

35. Total government resources are made up from the sum of different budgets: the Republican (central), the state union, local governments and EBFs. As seen from *Table 7* below, a total of 43.2 percent of the total expenditure for the consolidated government

[41] Arrears information from public enterprises is not reported routinely.

budget comes from extra-budgetary expenditures, including the MSSOs. Figures below have been netted out for transfers between budgets and funds.

Table 7. Estimate of the Composition of expenditure for the 2005 general government budget [42]

		In percentage of total expenditure
Government of the Republic		33.8
Local government		16.2
State Union		6.8
Pension funds	43.2	25.8
Health insurance funds		13.4
Labor funds		1.7
Other extra-budgetary social security funds		2.4
Total[43]		100

Source: IMF estimate, March 2006

36. The PEFA indicator for comprehensiveness of the information included in the budget documentation (PI-6) is measured as the share of nine selected benchmarks for information in the budget documentation most recently issued by the central government. The nine benchmarks are as follows: (1) Macro-economic assumptions, including at least estimates of aggregate growth, inflation and exchange rate; (2) Fiscal deficit, defined according to GFS or other internationally recognized standard; (3) Deficit financing, describing anticipated composition; (4) debt stock, including details for the beginning of the current year; (5) Financial assets, including details for beginning of the current year; (6) Prior year’s budget (either the revised budget or the estimated outturn), presented in the same format as the budget proposal; (8) Summarized budget data for both revenue and expenditure according to the main heads of the classifications used (see PI-5), including data for the current and previous year; and (9) Explanation of budget implications of new policy initiatives, with estimates of the budgetary impact of all major revenue policy changes and/or some major changes to expenditure programs. Meeting 7-9 of the benchmarks qualifies for an “A” score; 5-6 for a “B” score; 3-4 for a “C” score, and; 2 or less produces a “D” score.

37. The budget for 2006 contained summary information about the basic macro-economic assumptions (Benchmark 1) and included information about the overall fiscal deficit (surplus) (Benchmark 2), debt stock (Benchmark 4) and summarized budget data for both revenue and expenditure according to the main heads of the economic

[42] Social contributions from employers subtracted to avoid double accounting. Estimates are still under revision. IMF totals include expenditures financed by own-source revenues and cannot be reconciled with actuals presented in table 3 and 4.
[43] IMF estimates total at RSD 701.0 billion.

classifications (Benchmark 8). The budget for 2006 also provides information about how the budget surplus will be spent (Benchmark 3). However, the budget and the budget memorandum was lacking basic information about the composition of financial assets (Benchmark 5), prior year's budget or estimated outturn (Benchmark 6) and explanation of budgetary implications of policy initiatives (Benchmark 9). With six out of nine benchmarks being met, the score for this indicator is set at **B**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-6: Comprehensiveness of information included in the budget documentation	Despite recent improvements, the annual budget documentation is still lacking key information such as previous years' estimated outturns.	**B**

PI-7: Extent of unreported government operations

Dimensions to be assessed: (i) the level of extra-budgetary expenditure (other than donor-funded projects) which is unreported; i.e. not included in fiscal reports; and (ii) income/expenditure information on donor-funded projects which is included in fiscal reports.

38. **No major unreported expenditures exist, although the annual financial statements for the years 2002 to 2005 have not been made public or presented to the National Assembly.** The expenditures financed through "own-source revenues" are reported only in the yearly financial statements while EBFs (other than MSSOs) are reported in the MOF's "Public Finance Bulletin" introduced in the fourth quarter of 2004 **(dimension (i) score - A)**.

39. Unlike expenditures funded from own-source revenues and other EBFs, the MSSOs have separate but similar budgeting and reporting requirements to the DBBs. Also the revenue and expenditure reports for the MSSOs are made public in the "Public Finance Bulletin". In terms of day-to-day cash management, the most significant MSSOs, including the Health Insurance Fund, are however not part of the Interim Treasury Ledger System (ITLS).

40. **Aggregate data revenues provided for projects funded from both loans and grants were included in the annual budgets and annual financial statements** and have been included in the Ministry of Finance's "Public Finance Bulletin" since the fourth quarter of 2004. Data on grant-funded projects are provided by the Ministry of International Economic Relations' ISDACON[44] website and included in the regular annual fiscal reports. Although it is difficult to assess capital spending funded by foreign loans and grants reported as "own source" revenues in the Budget Beneficiaries annual financial statements, this is probably not done consistently and many expenditures funded by such assistance have traditionally not been fully reported through the budget system (**dimension (ii) score – B**). The score for the indicator is set at **B+**.

[44] The Inter-Sectoral Development and Aid Coordination Network..

INDICATOR	BRIEF EXPLANATION	SCORE
PI-7: Extent of unreported government operations	The level of unreported government expenditure is insignificant and full inclusion of information on loans and at least 50 percent of grant funding is provided.	**B+**

PI-8: Transparency of inter-governmental fiscal relations

Dimensions to be assessed: (i) transparent and rule-based system in the horizontal allocation among sub-national (SN) governments of conditional and unconditional transfers from central governments (both budgeted and actual allocations); (ii) timeliness and reliable information to SN governments on their allocations from central government for the coming year; and (iii) extent to which consolidated fiscal data is collected and reported for general government according to sectoral categories.

41. **Intergovernmental fiscal relations in Serbia were going through major reforms over the last couple of years, resulting in more transparency and objectivity in allocations to local governments.** Most importantly, as of July 2006, Serbia has a new Law on Local Self-government Financing. This law has modified the previously existing system of intergovernmental fiscal relations to make it more transparent and predictable by clearly defining sources of local revenues and establishing an explicit formula for distributing intergovernmental transfers. The total amount of funding for the non-earmarked transfers for all municipalities is now fixed at 1.7 percent of projected GDP and clear rules are specified for the allocation of transfers among individual municipalities. Transfers would primarily serve to reduce disparities in revenues among municipalities. According to the formula specified in the law, sufficient funds would be transferred to each municipality to bring the per capita tax revenues of all local governments up to 90 percent of the national average.

42. The new law also provides for earmarked transfers to finance certain functions to be delegated to local governments in the future. Primary health care will begin to be decentralized in 2007. Primary and secondary education will follow. The formulas to be used to finance these functions are to be developed by the ministries of health and education, respectively. Performance against this indictor should be reevaluated once these two functions have been decentralized and the new financing system is put in place. **(Score for dimension (i) is A.)**

43. **Recent legal changes set the basis for more predictability to local governments on their allocations from central government.** This primarily relates to adoption of clear calendar of activities of both central and local governments. The local authorities are provided for the Government-adopted Budget Memorandum six months in advance (June 1) of the scheduled submission of the budget to the National Assembly (November 1), giving sufficient time to make adjustments. Thus, local governments are provided reliable information on the allocations to be transferred to them ahead of

completing their budget proposals, making changes to the proposal possible (**dimension (ii) score - B**).

44. **Reporting and consolidation of fiscal operations has been improved but there is still room for further improvements.** Fiscal reports of all sub-national governments are provided to the MOF in accordance with the budget economic classification on a monthly basis. The monthly bulletin publishes these data separately for all municipalities and Vojvodina. Since 2006, municipalities also collect and report monthly fiscal operations based on functional classifications; however these reports are not regularly published. Consolidation of all layers of government is done only annually and could be significantly increased. Local governments regularly report on any new borrowing to the Treasury. On this basis, the **score for dimension (iii) is set at B** and the score for the indicator at **B+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-8: Transparency of inter-governmental fiscal relations	The rules regulating allocations to sub-national governments are not fully transparent. Fiscal reports from sub-national governments are provided on a current basis.	**B+**

PI-9: Oversight of aggregate fiscal risk from other public sector entities

Dimensions to be assessed: (i) extent of central government monitoring of autonomous government agencies (AGA) and Public Enterprises (PE); and (ii) extent of central government monitoring of SN governments` fiscal positions.

45. **Data on Public Enterprises are generally available but quality is questionable.** In the 2005 Republican government budget, more than 7 percent[45] of the budgeted expenditures consisted of subsidies to various non-financial public corporations (number 451 in the economic classification)[46]. The budget document does not provide references to the legal basis for these corporations or information about the financial reporting requirements and, only in some cases, a brief description of the specific intended purpose of the subsidy. Business plans of Public Enterprises founded by the Republic are submitted to the Government for adoption. Financial statements for the state owned enterprises are reported to the National Bank of Serbia and disclosed to the public.

[45] In the 2005 budget subsidies were set at RSD 32,402.30 million with a total budget of RSD 416,592.00 million (7.8 percent). A small proportion of subsidies were to financial public corporations (RSD 251.00 million)

[46] 85.5 percent of subsidies are provided for the following four areas: (i) support for agricultural production (35.5 percent); (ii) subsidies to the state railroad company (ZTP) (26.6 percent); (iii) Restructuring of State-Owned Companies (16.6 percent); and (iv) state television (RTS) (6.8 percent). Numbers are based on IMF estimates for 2005.

For an overview of the most significant SSOEs and the subsidies provided to them, see *Table 8* below.

46. **In July 2005, an IMF report concluded that the data quality for the large state-owned companies is poor and that more transparency and accountability is needed to address governance problems and improve public understanding of SSOE performance.** The report provides essential information about the budget subsidies and other deficit financing for 19 SSOEs[47]. An overview showing budget subsidies and other deficit-financing sources for 2003 and 2004 is presented in *Table 8* below. The IMF concludes that the SSOEs' deficit rose from an estimated 1.2 percent of GDP in 2003 to 1.6 percent of GDP in 2004 and that the increases in deficits in 2004 reflects deteriorating operating results in the energy companies and lower deficits in socially owned enterprises. It also finds that data on subsidies and arrears confirm that the reduction of subsidies to public utilities or payment of arrears by public utilities may have contributed to deficits. As seen in *Table 8*, total budgetary subsidies and indirect support in the form of payment arrears to NIS and EPS declined from 2003 to 2004.

47. **The Sector for Public Enterprises and State Assistance in the Treasury of MOF regularly monitors the financial performance of public enterprises, while socially-owned enterprises are monitored by the Ministry of Economy. Public utility enterprises are monitored by local governments. Finally, the Sector for Public Debt of the Treasury Department monitors public debt and issuance of guarantees.** Although the reporting on entities monitored by the sub-national governments have improved, not all aspects for public enterprises are covered and a consolidated overview is missing **(score for dimension (i) – C**). Currently the IMF Resident Representative's Office is undertaking a more comprehensive survey of public enterprises in cooperation with the Government. The annual audited financial statements, in-year financial reports, annual plans, as well as new debt contracting for sub-national governments are monitored by the unit, but a consolidated overview is missing. (**dimension (ii) score set – C**). On this basis the score for the indicator is set at C.

48. **Strong comprehensive oversight of public enterprises is needed.** The Government's current plans to enable public-private partnerships to undertake major road-constructions, such as the planned Horgoz-Pozega highway, could potentially generate considerable contingent liabilities and add to the existing fiscal risks. This is also reported on by the IMF in the Sixth Review under the Extended Arrangements (Country Report No. 06/58, p. 65), which provided a number of recommendations to avoid adding to existing fiscal risks.

[47] IMF Country Report No. 05/232 of July 2005: Serbia: Selected Issues and Statistical Annex. As above the line data are not available and the SSOEs' cash deficits are estimated from the financing side (subsidies and borrowing).

Table 8. State and Socially-Owned Enterprises in Serbia 2003-2004[48]

Billion RSD		**Budget subsidies**		**Bank financing**		**Change in arrears (excl. penalties)**				**Total**	
						To EPS		To NIS			
Name	Sector	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
1) State-owned enterprises		**12.1**	**13.4**								
NIS	Energy-oil and gas	0.0	0.0								
EPS	Electricity and mining	0.0	0.0								
PTT	Post	0.0	0.0								
ZTP	Transport – railway	9.5	8.9								
RTS	Media	1.9	3.2								
JAT	Air transportation	0.0	0.0								
Airport Beograd	Transport – airport	0.0	0.0								
Telekom	Telecommuni-cation	0.0	0.0								
Mines	Mining	0.7	1.3								
2) Socially owned enterprises [49]		**6.9**	**6.5**								
Other		3.4	3.3								
Total for 10 largest socially-owned ("Other" excluded)		**3.4**	**3.3**	**1.2**	**0.6**	**0.8**	**1.1**	**2.1**	**0.1**	**7.6**	**5.1**
RTB Bor	Mining	0.8	0.5	0.0	0.0	0.5	0.6	-0.1	0.1	**1.2**	**1.2**
Zastava	Manufacturing	2.1	1.9	-0.1	.0.0	0.1	0.2	0.3	0.2	**2.3**	**2.3**
Azotara Pancevo	Chemical	0.0	0.1	0.0	0.1	0.0	0.0	0.5	0.2	**0.5**	**0.4**
Matroz	Chemical	0.1	0.2	0.0	0.0	0.1	0.1	0.0	0.0	**0.3**	**0.3**
Viskoza	Chemical	0.1	0.1	0.0	0.0	0.0	0.1	0.3	0.0	**0.4**	**0.3**
Magnohrom	Manufacturing	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.1	**0.1**	**0.2**
Fabrika Vagona Kraljevo	Manufacturing	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	**0.3**	**0.0**
Industrija Stakla Pancevo	Glass industry	0.1	0.0	0.0	0.0	0.0	0.0	0.2	0.0	**0.2**	**0.0**
HIP Petrohemija	Petrochemical	0.0	0.0	1.3	0.5	0.1	0.0	0.7	-0.4	**2.1**	**0.1**
Ivo Lola Ribar	Manufacturing	0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	**0.1**	**0.2**

Source: IMF Country Report No. 05/232: Selected Issues and Statistical Annex, July 2005.

[48] Does not include SSOEs owned and operated by sub-national governments. There may also be considerable transfers to SSOEs from unreported EBFs such as the Transition Fund.
[49] Include enterprises under reconstruction. Discrepancies in totals of 0.1 billion are due to rounding errors.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-9: Oversight of aggregate fiscal risk from other public sector entities	Although monitoring of financial performance is done, not all aspects are covered and there is no systematic, annual reporting of financial risks of public enterprises and sub-national governments in Serbia.	**C**

PI-10: Public access to key fiscal information

49. The PEFA indicator for public access to key fiscal information (PI-10) assesses the observance of the following six dimensions: (i) Annual budget documentation; (ii) In-year budget execution reports[50]; (iii) Year-end financial statements; (iv) External audit reports; (v) Contract awards; and (vi) Resources available to primary service units.[51] Of these elements: "(i) Annual budget documentation"; (ii) In-year budget execution reports; and (v)"Contract awards" are available to the public in Serbia. On this basis, the score for the indicator is set at **B**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-10: Public access to key fiscal information	The government makes 3 of the 6 listed types of information available to the public.	**B**

D. BUDGET CYCLE

(i) Policy based budgeting

PI-11: Orderliness and participation in the annual budget process

Dimensions to be assessed: (i) existence and adherence to a fixed budget calendar; (ii) clarity and comprehensiveness of and political involvement in the guidance on the preparation of budget submissions; and (iii) timely budget approval by the legislature or similarly mandated body.

[50] Budget execution reports (Bulletins) are now available on the MOF`s website since end 2004. Whereas it presents budget execution figures as per economic classification, there is no comparison between the original budgets and actual outcomes.

[51] (1) Annual budget documentation: A complete set of documents can be obtained by the public when it is submitted to the legislature; (2) In-year budget execution reports: The reports are routinely made available to the public within one month of their completion; (3) Year-end financial statements: The statements are made available to the public within six months of the completed audit; (4) External audit reports: All reports on central government consolidated operations are made available to the public within six months of the completed audit; (5) Contract awards: Award of all contracts with a value of above approximately USD 100,000 equivalents are published at least quarterly through the press or website; and (6) Resources available to primary service units: Information is publicized or available upon request at least annually for primary service units with national coverage (such as elementary schools or primary health clinics) in at least two sectors. If the government makes available to the public 5-6 of the 6 listed types of information the score is set at "A", whereas the availability of 3-4 of the 6 types produces a "B" score, 1-2 a "C" score and the absence of all 6 types gives a D score.

50. The budget process defined by the Budget System Law (BSL) allocates more time than the previous law to budget planning, preparation, scrutiny and debate. The BSL provides a clear timetable for budget submissions, which has largely been adhered to for the last three fiscal years (**score for dimension (i) set at A**). The strategic planning phase is, however, not recognized in the budget calendar, and more time is needed for line ministries' medium-term planning and budgeting under a medium-term budget constraint. The Budget Memorandum is comprehensive and clear and includes indicative ceilings per economic and administrative, but not functional, classification. It appears, however, that the Memorandum is almost exclusively produced by the responsible department of the MOF, with few indications of involvement by policy-makers or even other departments. Approval of the indicative ceilings in the Budget Memorandum takes place before Budget Beneficiaries have completed their submission (**score for dimension (ii) - B**). According to the BSL, the National Assembly has 1.5 months to reach agreement on the budget (between November 1 and December 15). Simple procedures for the National Assembly's budget review exist and are generally respected. The **score for dimension (iii) is set at A**, while the overall score for the indicator is set at **A**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-11: Orderliness and participation in the annual budget process	In keeping with the provisions of the Budget System Law, a budget circular (the Budget Memorandum) and an improved and clear budget calendar has been introduced and is largely adhered to.	**A**

PI-12: Multi-year perspective in fiscal planning, expenditure policy and budgeting

Dimensions to be assessed: (i) preparation of multi-year fiscal forecasts and functional allocations; (ii) scope and frequency of debt sustainability analysis; (iii) existence of sector strategies with multi-year costing of recurrent and investment expenditure; and (iv) linkages between investment budget and forward expenditure estimates.

51. Since the budget for fiscal year 2002, the MOF has prepared a Budget Memorandum containing forecasts of fiscal aggregates on the basis of the main categories of economic classification for two years on a rolling annual basis. Since the 2007 budget, the Budget Memorandum will cover three years, but, mainly due to weaknesses in macro forecasting, the links between multi-year estimates and subsequent setting of annual budget ceilings are not clear (**score for dimension (i) - C**). Debt sustainability analyses, including external and domestic debt, are undertaken regularly and published by the National Bank of Serbia on their website. The latest analysis was made in connection with the preparation of the Budget Memorandum for 2006 (**score for dimension (ii) - B**). Sector strategies are prepared for all key sectors but they do not include costing of investments and recurrent expenditure (**score for dimension (iii) - D**). It appears from the Budget Memorandum, as well as from the practices observed, that many investment decisions have weak links to the sector strategies and, in only a few cases, are their recurrent cost implications brought forward in the budget estimates (**dimension (iv) score set at C**). On this basis, the score for the indicator is set at **C**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-12: Multi-year perspective in fiscal planning, expenditure policy and budgeting	The Budget Memorandum contains key fiscal forecasts and sector strategies, but there is no link between strategies on the one side and actual costing of investments and recurrent costs on the other.	**C**

(ii) Predictability and Control

Revenue Collection

PI-13: Transparency of taxpayer obligations and liabilities

Dimensions to be assessed: (i) clarity and comprehensiveness of tax liabilities; (ii) taxpayer access to information on tax liabilities and administrative procedures; and (iii) existence and functioning of a tax appeals mechanism.

52. The rules and procedures for the newly-introduced VAT are clear, and the introduction of new legislation has eliminated most tax exemptions and reduced the discretionary powers of the Tax Administration (**score for dimension (i) is set at B**). Taxpayers appear to have relatively easy access (for instance through the internet) to comprehensive, user friendly and up-to-date information on tax liabilities and administrative procedures for some of the major taxes. Whereas the information provided on VAT appears to be comprehensive, the information on income taxes appears less comprehensive, although advice is offered to clients, for instance through the Tax Administration's website (**dimension (ii) score - B**). An appeals system has been established in accordance with the Tax Administration and Procedures Law (TAPL) Part 4. Accordingly, appeals can be submitted against first-level rulings. The second-level rulings are the responsibility of five units of the Tax Administration. In each case the procedure is authorized by the Minister of Finance, but the decision is made by the relevant Tax Administration unit. Finally, tax cases can be tried in regular Courts with the Supreme Court as the ultimate course of appeal. Whereas the tax appeals system has been established, it appears that it still needs redesigning to be considered fair, transparent and effective, as it appears to leave considerable discretion to the authorities and does not provide for arbitration in cases of dispute by an independent, specialized arbitration body (for instance a Tax Tribunal) (**score for dimension (iii) - C**). The score for the indicator is set at **B**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-13: Transparency of taxpayer obligations and liabilities	Whereas a clear legal framework for tax procedures and administration is in place, transparency and appropriate protection for taxpayers against arbitrary rulings could still be improved.	**B**

PI-14: Effectiveness of measures for taxpayer registration and tax assessment

Dimensions to be assessed: (i) control in the tax payer registration system; (ii) effectiveness of penalties for non-compliance with registration and declaration obligations; and (iii) planning and monitoring of tax audit and fraud investigation programs.

53. Whereas taxpayers are registered in database systems for individual taxes, these systems are not fully and consistently linked to other relevant systems. This is somewhat compensated for by control activities, including reconciliations, carried out as part of the internal control functions (**score for dimension (i) - C**). In accordance with Article 75 of the TAPL, interest on underpaid or overpaid taxes and secondary tax duties shall be calculated and paid at a rate 15 percent greater than the annual discount rate of the National Bank. Given that the discount rate of the National Bank is 8.5 percent and the market rate on an overdraft in RSD varies between 24-30 percent, the penalty interest appears to be set at an appropriate level. If proven in the court of law, tax evasion is punishable with fines and up to 10 years' imprisonment, depending on the size of the tax evasion. On this basis, it appears that penalties for all areas of non-compliance are set sufficiently high as to act as a deterrent (**score for dimension (ii) - A**). There is a continuous program of tax audits and fraud investigations, including through an internal control group, but audit programs are not based on clear risk assessment criteria (**score for dimension (iii) - C**). On this basis the overall score of the indicator is set at **B**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-14: Effectiveness of measures for taxpayer registration and tax assessment	The effectiveness of measures for taxpayer registration and tax assessment is moderately low and systems are not integrated, nor are practices harmonized.	**B**

PI-15: Effectiveness in collection of tax payments

Dimensions to be assessed: (i) collection ratio for gross tax arrears; (ii) effectiveness of transfer of tax collection to the Treasury by revenue administration; and (iii) frequency of complete account reconciliation between tax assessments, collections, arrears records and receipts by the Treasury.

54. The first dimension of the indicator assesses the collection effort of tax arrears. This indicator seeks to compare annual collection rates over two years and data is not readily available for measuring that dimension. Data on the stock of arrears at end-2004 and end- 2005 is available.

Table 9. Tax Arrears

	2004	**2005**
Stock of arrears end of year	20.9	14.3
Aggregate revenue	334.3	418.5
Arrears in percentage of total revenue	6.3	3.4

Source: Tax Department

The 2005 figure does not include arrears on VAT introduced in 2005. The stock of arrears is influenced by the large number of state-owned enterprises in the privatization process. According to the law on privatization, the tax authorities (and other creditors) cannot collect their debt before the privatization process has ended. The share of arrears from SOEs under privatization could be as high as 50 percent, but the information on the collection ratio, as well as total arrears segregated between companies in the privatization process, and the rest of the debt is not clearly reported by the tax authorities. As the privatization process is progressing, the stock of arrears will decrease considerably. The arrears in percentage of total revenue are above 2 percent which would warrant a D score. Since the collection rate of tax arrears is unknown, the **score for dimension (i) is D.**

55. Tax revenues are paid into accounts controlled by the Treasury and each taxpayer can be identified. On a daily basis the Treasury provides information about account balances to the Tax Administration, which is then responsible for reconciliation and identification of arrears (**score for dimension (ii) - A**). Reconciliation of tax assessments, collections, arrears and transfers to Treasury takes place monthly (**score for dimension (iii) - A**). The overall score while incomplete, as discussed above, is **D+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-15: Effectiveness in collection of tax payments	While tax obligations are clear and easy to meet, tax arrears are significant.	**D+**

Treasury and Cash Management

56. **A time-bound plan for the implementation of a Modernized Treasury System (MTS) providing treasury services for all budget beneficiaries has been established and is being implemented.** The Ministry of Finance is in the process of creating a comprehensive Treasury Single Account (TSA) system, referred to as the Modernized Treasury System (MTS) or the Financial Management Information System (FMIS). The development has started with the existing Interim Treasury Ledger System (ITLS), which

has been operational since April 15, 2003 and will remain as a transitional module until the implementation of the new applications. Through the European Agency for Reconstruction (EAR) the EU is financing a project to support the Ministry of Finance to design and implement the MTS, which has already suffered from some delays. An action plan to set up the MTS, which was presented to the Ministry of Finance in March 2005, was also supported by the EAR.

57. The Minster of Finance has appointed a special IT Advisor to supervise the implementation and detailed technical specifications of the project. The PPA, now an integral part of the Treasury is a key player in the implementation of the MTS, which is scheduled to be completed by the end of 2007. The project aims to complete the consolidation of the TSA and enlarge the treasury network to offer treasury services not only to DBBs but also to the IBBs currently serviced by the PPA. It should also provide improved debt and cash management and new functionalities to ensure central access to accounting information from all Budget Beneficiaries. The Treasury is also working on an interim solution to ease the current administrative burden of manually processing payment orders for the users of the ITLS by enabling electronic submission of payment orders. Due to the very tight timetable for the MTS implementation, some project delays can be expected.

PI-16: Predictability in the availability of funds for commitment of expenditures

Dimensions to be assessed: (i) extent to which cash flow is forecasted and monitored; and (ii) reliability and horizon of periodic in-year information to budget users on ceilings for expenditure commitments; and (iii) frequency and transparency of adjustments to budget allocations, which are decided above the level of management of Budget Users.

58. Cash flow forecasts are prepared annually and updated quarterly, based on information on actual cash inflows and outflows (**dimension (i) score - B**). Budget beneficiaries are provided information about commitment ceilings on a three months' rolling basis, but ceilings are not always reliable and cause delays and disturbances in task execution. Better projections on the revenue side are needed to improve reliability (**dimension (ii) score - C**). In-year reallocations of less than five percent of the appropriation in question are allowed for DBBs. Such adjustments appear to be frequent but they are done in accordance with the provisions in the BSL, which gives considerable flexibility to Direct Budget Beneficiaries to redirect appropriations. Whereas section 7 of article 41 of the BSL establishes that appropriations may be redirected "for certain expenditures up to 5 percent of the appropriation for the expenditure being reduced" there are no explicit limitations on the number of such reallocations that can be made during the year. No statistical information about the frequency of budget reallocations within the 5 percent limit or with MOF approval was available to the team but adjustments are frequent. Measures to "benchmark" budget institutions are being implemented with regard to the number of reallocations **(dimension (iii) score – C**). The overall score for the indicator is therefore **C+**.

59. Budget revisions requiring the approval of the National Assembly have been initiated three times within the last three fiscal years: (i) Revision of 2003 budget (April 3, 2003); (ii) Revision of 2004 budget (October 25, 2004); and (iii) Revision of 2005

budget (July 15, 2005). Although the 2003 revision was never formally passed by the National Assembly, it is noteworthy that the proposed revision laws are characterized by an almost complete lack of narrative and explanatory text. At the same time the revised budget figures are not presented together with the original budget figures but in a way that does not allow a direct comparison with the originally adopted budget. An analysis of the budgets and budget revisions for the period 2003-2005 reveals an overall trend of reducing subsidies and capital investments and spending on goods and services, while increasing transfers to the MSSOs, including pension funds. Typically, the budget revisions bring the revised expenditure budgets very close to actual expenditure reported by the MOF at the end of the year.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-16: Predictability in the availability of funds for commitment of expenditures	The lack of predictability in availability of funds for commitment of expenditures hampers budget execution. Reallocations appear to be frequent, although undertaken in accordance with current rules.	C+

PI-17: Recording and management of cash balances, debt and guarantees.

Dimensions to be assessed: (i) quality of debt data recording and reporting; (ii) extent of consolidation of the government's cash balances; and (iii) systems for contracting loans and issuance of guarantees.

60. Domestic and foreign debt records are updated and reconciled on a quarterly basis. Information on the debt stock of the Government of the Republic is published in the monthly Bulletin, issued by the MOF. The available debt data is considered to be of fairly high quality and complete (**dimension (i) set - B**). Calculation and consolidation of cash balances for some 9,000 Budget Beneficiaries with sub-accounts[52] in the PPA take place daily. Some of the MSSOs, including the Health Insurance Fund[53], do not make payments through the PPA system and perform their own reconciliation of cash balances (including the accounts of the 28 operating branch offices) in connection with the quarterly and annual reporting to the MOF (**dimension (ii) score - B**). A single responsible government agent, the MOF, approves central government contracting of loans and issuance of guarantees, which are limited, for total debt and/or guarantees set in the annual budget laws. The BSL provides the general guidelines for the issuance of government guarantees (Articles 52-58), while more detailed criteria for the issuance of guarantees are provided through provisions of the law on Public Debt (Official Gazette No. 61/2005). As an indicator of the level of implicit or explicit contingent liabilities faced by the Government, the stock of banking loans by the eight largest state-owned enterprises amounted to RSD 11.0 billion in 2004. This represented an increase of 155.8

[52] Some 23,000 sub-accounts administrated by the PPA.

[53] In 2005 the Health Insurance Fund alone constituted 13.4 percent of total Republican expenditure.

percent in two years from RSD 4.3 billion in 2002[54]. Accordingly, the **score for dimension (iii) is set at B** and the score for the indicator is set at **B**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-17: Recording and management of cash balances, debt and guarantees.	The quality and frequency of debt recording and reconciliation is considered fairly high and debt records are complete.	**B**

PI-18: Effectiveness of payroll controls

Dimensions to be assessed: (i) degree of integration and reconciliation between personnel records and payroll data; (ii) timeliness of changes to personnel records and payroll; (iii) internal controls of changes to personnel records and payroll; and (iv) existence of payroll audits to identify control weaknesses and-or ghost workers

61. Currently aggregated, central reconciliation between payroll and personnel data exists for around 170 DBBs. Primary and secondary schools will be covered in early 2007 and army and police will be covered later in 2007. Payroll data seems to be adequately documented and checked (**dimension (i) score - B**). It is the individual BB's personnel units that are responsible for updating the Ministry of Public Administration and Local Government on changes in personnel details, and submitting salary sheets to their respective ministries. Personnel data should be updated on a monthly basis in connection with the submission of time sheets, while some retroactive adjustments are made occasionally (**dimension (ii) score - B**). The authority and basis for making changes to personnel records and payroll is clear. Until 2006, ministries and other central DBBs still submitted timesheets to the Mutual Services Agency (MSA), which processed and kept records of submitted timesheets and forwarded summary payment requests to the Treasury for formal endorsement before payments were processed. However, since January 1, 2006 the payroll has been managed and accounted for directly by the Treasury (**dimension (iii) score is set at B**). The internal audit has conducted audits of the payroll as part of most of their audits (15 in 2004 and 2005). However, because of limited overall coverage of internal audits, these have been partial audits only **(dimension (iv) score is set at C).** The indicator score is set at **D+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-18: Effectiveness of payroll controls	Whereas adequate systems to control payroll comparing with the HR database system are being implemented, the lack of sufficient audit coverage does not ensure full integrity of data.	**C+**

[54] The gas company, NIS, accounted for RSD 6.7 billion and the postal company, PTT, accounted for RSD 2.2 billion. Source: IMF country report no. 05/232, p. 37.

Public procurement

PI-19: Competition, value for money and controls in procurement

Dimensions to be assessed: (i) evidence on the use of open competition for awards of contracts that exceed the nationally established monetary threshold for small purchases; (ii) extent of justification for use of less competitive procurement methods; and (iii) existence and operation of a procurement complaints mechanism.

62. **Although more than half of the procurement is done using open competition, the required justification for the use of less competitive procurement methods, as well as the operation of a satisfactory complaints mechanism, is not adequate.** Based on the information provided from the Public Procurement Office, the public procurement system of Serbia consists of 12,000 purchasers and 80,000 bidders who conclude over 250,000 contracts each year, worth in excess of USD 1.5 billion. It is recognized that open competition in the award of contracts provides a basis for achieving efficiency in acquiring inputs and value for money in delivery of programs and services for the government. However, the use of open competition has not increased between 2002 and 2004. Available data on public contract awards (see *table 10* below) show that 69 percent (more than 50 percent but less than 75 percent) of contracts above the threshold are awarded on a basis of open competition, but the data may not be accurate (**dimension (i) score – B**).

Table 10. Choice of Procurement Procedure 2002-2004

Method	Year 2002	Year 2003	Year 2004
Open Procedure	45%	63%	50%
Restricted Procedure	25%	12%	19%
Negotiated Procedure	30%	25%	31%

Source: Report on Awarded Public Procurement Contracts in Serbia for 2004

The legal framework is ambiguous when it comes to a preference for open and restricted versus negotiated procedures. This is evidenced by the use of negotiated procedures, which was at a slightly higher level in 2004 compared to 2002 (31 percent compared to 30 percent). The team has found that proper justification for the use of less competitive procurement methods is typically weak or missing (**dimension (ii) score – C**). A process exists for submitting and addressing procurement complaints, but it is designed poorly and does not operate in a manner that provides for timely resolution of complaints (**dimension (iii) score – C**). The overall score for the indicator is set at **C+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-19: Competition, value for money and controls in procurement	Public procurement management suffers from inefficiencies due to inadequate enforcement of competitive mechanisms, lack of clear justification for the use of less competitive procurement methods, and inefficient complaint mechanism.	**C+**

Internal control

PI-20: Effectiveness of internal controls for non-salary expenditure

Dimensions to be assessed: (i) effectiveness of expenditure commitment controls; (ii) comprehensiveness, relevance and understanding of other internal control rules-procedures; and (iii) degree of compliance with rules for processing and recording transactions.

63. Direct Budget Beneficiaries are required to establish “financial services” to prepare and execute the budget. In some cases DBBs have appointed controllers that are independent of the financial services to perform ex-ante checks of the legality of individual commitments and payments. In other cases legality is ensured via the double signature of the head of the DBB and the head of the financial service for authorizing commitments and payments. The existence of considerable payment arrears (see indicator PI-4 above) however suggests that these controls are only partially effective in limiting commitments to actual cash availability (**dimension (i) score - C**). In the DBBs and the EBFs visited, financial services’ managers were appropriately aware of the basic MOF regulations and internal procedures for authorizing commitments and payments. Whereas ex-ante controls for even small transactions are clearly regulated and routinely carried out, written procedures and appropriate practices for approving and monitoring the implementation of contracts are not in place (**score for dimension (ii) - C**). In a repeated reference to the existence of a relatively large stock of expenditure arrears, it appears that while rules are complied with for the majority of transactions, the use of simplified procedures in unjustified situations is a matter of concern (**dimension (iii) score set at C**). On the basis of the above, the score for the indicator is set at **C**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-20: Effectiveness of internal controls for non-salary expenditure	In line with the provisions of the Budget System Law, financial controls of payments are carried out but appropriate procedures and practices for entering and currently monitoring large contractual obligations are missing.	**C**

PI-21: Effectiveness of internal audit

Dimensions to be assessed: (i) coverage and quality of the audit function; (ii) frequency and distribution of reports; and (iii) extent of management response to internal audit findings.

64. While serious efforts have gone into developing methodological guidelines and training of staff, available staff resources for the Budget Inspectorate and the MOF’s Internal Audit Unit (IAU) are limited to 17 and 11 respectively. Both departments have government-wide inspection and audit responsibilities but are the only specialized ex-

post financial control units evaluating entities in the administration of the Republic. Internal audit is deemed functional for at least the most important central government entities. The MOF IAU's audits comprise systems evaluating and monitoring elements. Whereas the internal audit methodology being developed reflects relevant international standards (ISPPIA), it does not yet cover all audit areas. It is estimated that IAU spend at least half their time on systemic issues (**dimension (i) score - C**). In 2004 and 2005, the MOF's IAU carried out 15 audits, producing approximately 300 recommendations. Audit reports are submitted to and discussed with the auditee, but as the SAI is not established, information is not shared with them and this negatively impacts the score (**dimension (ii) score - C**). The follow-up on reports has been prompt and comprehensive for the first two years of operation (**dimension (iii) score – A).**

Table 11. Number of Internal Audits and Recommendations 2004 and 2005

Year	Number of audits	Num. of recommendations provided	due	Number of implemented recommendations
2004	3	98	98	84
2005	12	369	222	220

The legal framework for internal audit has still to be completed and the MOF's IAU needs to be fully staffed. Similarly, managers across the administration need to be better informed about the role of internal audit. The overall score for the indicator is set at **C+.**

INDICATOR	BRIEF EXPLANATION	SCORE
PI-21: Effectiveness of internal audit	The Ministry of Finance has established an IAU within the Budget Inspection and Audit Department but it has very limited staff capacity to audit and assess financial management and control systems of all Budget Beneficiaries. Follow-up of the audits has been prompt.	**C+**

(iii) Accounting, Recording and Reporting

PI-22. Timeliness and regularity of accounts

Dimensions to be assessed: (i) regularity of Bank reconciliations; and (ii) regularity of reconciliation and clearance of suspense accounts and advances.

65. The Public Payment Agency (PPA) which was merged with the Treasury on August 1, 2005, performs daily reconciliations between the cash balances of Direct Budget Beneficiaries (DBBs) bank accounts and transaction records in its payments and accounting systems (**dimension (i) score - A**). Suspense and advance accounts are cleared at least annually. Some accounts may have uncleared balances brought forward (**dimension (ii) score - B**). It is foreseen that the ongoing implementation of the Modernized Treasury System (MTS) system, will integrate all Budget Beneficiaries into

the Treasury Single Account and that the Indirect Budget Beneficiaries bank accounts will be closed. On the basis of the above the score for the indicators is set at **B+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-22. Timeliness and regularity of accounts reconciliation	Bank accounts for ministries and other Direct Budget Beneficiaries are reconciled and cleared daily, whereas accounts of Indirect Budget Beneficiaries (such as primary schools and health institutions) are not and may have idle balances. Suspense and advance accounts are cleared at least annually.	**B+**

PI-23: Availability of information on resources received by service delivery units

Dimension to be assessed: collection and processing of information to demonstrate the resources that were actually received (in cash and in kind) by the most common front-line service delivery units in relation to overall resources made available to the sector(s), irrespective of which level of government is responsible for the operation and funding of these units.

66. Accounting and transactions systems managed by the PPA and the Treasury provide reliable information on all cash resources received by primary schools and health care institutions. The institutions do not receive in-kind resources. It is not clear to what extent reports are being produced and utilized based on the available information (**score for the indicator - B**).

INDICATOR	BRIEF EXPLANATION	SCORE
PI-23: Availability of information on resources received by service delivery units.	Whereas information about cash resources received by primary service units is available at least on an annual basis, and in-kind resources are not provided, it is not clear how this information is utilized.	**B**

PI-24: Quality and timeliness of in-year budget reports

Dimensions to be assessed: (i) scope of reports in terms of coverage and compatibility with budget estimates; (ii) timeliness and issue of reports; and (iii) quality of information.

67. As mentioned above, comparison to original budget figures is possible for main administrative headings using data from a MOF data bulletin, but only with some

recalculation of certain headings. Expenditures are captured both at the commitment and payment stages, but as it is common practice that the two are submitted to the Treasury at the same time, commitment information often adds no value (**score for dimension (i) - B**). The Treasury prepares monthly and quarterly summary reports with expenditure breakdowns as per economic classification. Reports on cash flows and monthly revenue reports are produced from the Treasury's accounting system typically within four weeks of the end of the previous month (**dimension (ii) score - A**). The implementation of a new chart of account, generally consistent with GFSM 2001, is being implemented. Although an adequate independent assurance mechanism is lacking, there is no other indication to question the accounting accuracy when comparing in-year reporting with the annual financial statements produced. The Bulletin does provide an explanation on the methodology used and this does not fundamentally compromise overall consistency and usefulness (**score for dimension (iii) - B**). The overall score for the indicator is set at B+.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-24: Quality and timeliness of in-year budget reports	Monthly and quarterly budget execution reports are submitted by Direct Budget Beneficiaries to the Ministry of Finance following a standard Chart of Accounts.	**B+**

PI-25: Timeliness of the presentation of audited financial statements to the legislature

Dimensions to be assessed: (i) completeness of the financial statements; (ii) timeliness of submission of the financial statements; and (iii) accounting standard used.

68. Since financial statements have not been presented to the National Assembly for the last four fiscal years, the score for this indicator is set at **D**[55]. While transaction data for the four fiscal years 2002-2005 are readily available from the PAA, no consolidated annual statements have been presented to the National Assembly. The provisions of the BSL set the deadline for submission of the final consolidated statement to the National Assembly as June 1 in the year following the fiscal year and their provisions have therefore not been complied with for the last four fiscal years. As mentioned previously, the MOF has produced the financial statements for the relevant years in a timely manner and these statements have been used for this report. However, due to the National Assembly's lack of timely decisions, the statements have not been audited and the SAI Council has not been established.

[55] PI-25 is measured through the assessment of these dimensions: (i) Completeness of the financial statements; (ii) Timeliness of submission of the financial statements; (iii) Accounting standards used.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-25: Timeliness of the presentation of audited financial statements to the legislature.	Consolidated annual financial statements for the fiscal years 2002, 2003, 2004 and 2005 have not been presented to the National Assembly for approval.	**D**

(iv) External Scrutiny and Audit

PI-26: The scope, nature and follow-up of external audit

Dimensions to be assessed: (i) scope of audits performed; (ii) timeliness of submission of audit reports to the legislature; and (iii) evidence of follow-up on audit recommendations.

69. A sub-committee under the Finance Committee of the National Assembly has been responsible for preparing the establishment of a Supreme Audit Institution (SAI). The finalization of the constitutional and legal framework for establishing an SAI has been expected and under way for a number of years, and was a short-term recommendation in the 2002 CFAA. The National Assembly and the Government has received advice and support from several multilateral and bilateral donors in conceptualizing the establishment of an SAI.[56] On May 18, 2005 the OSCE mission to Serbia and Montenegro organized and hosted a seminar to present and discuss the draft law. On November 14 2005, the law was formally adopted by the National Assembly but none of the formal appointments of the State Audit Institution's top management, a Council consisting of a President, a Vice President, and three members, have yet been made. The absence of an SAI means that the score for the indicator is set at **D**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-26: The scope, nature and follow-up of external audit.	External, independent audit is still to become reality. A law on the State Audit Institution was adopted by the National Assembly in November 2005 but no decisions on appointments or other actions have yet been taken to set up a functional institution.	**D**

PI-27: Legislative scrutiny of the annual budget law

Dimensions to be assessed: (i) scope of the legislature's scrutiny; (ii) extent to which legislature procedures are well established and respected; and (iii) adequacy of time for the legislature to provide responses to budget proposals.

[56] Bilateral donors have included the Swedish and Canadian International Development Agencies. The multilaterals include the EU, OECD/SIGMA and the OSCE.

70. The National Assembly's review of the annual draft budget includes consideration of fiscal policies and aggregates for the coming year and detailed estimates of expenditure. The revenue budget is, however, only presented at a very aggregate level. Whereas the Budget Memorandum that accompanies the budget also comprises some aggregate estimates for the subsequent three fiscal years, these are not presented in the actual budget, nor detailed as per economic or administrative classification (**score for dimension (i) - C**). Basic procedures for the legislature's review of the Budget are set out in the BSL, the Budget Memorandum and actual budget document and are largely respected (**dimension (ii) score - B**). According to the BSL, the National Assembly has 1.5 months to reach agreement on the budget (between November 1 and December 15) (**dimension (iii) score - B**). While clear rules exist for in-year budget amendments by the executive, which are usually respected, they do not allow for extensive administrative allocations[57] (**dimension (iv) score set at B**). Indicator score is set at **C+**.

INDICATOR	BRIEF EXPLANATION	SCORE
PI-27: Legislative scrutiny of the annual budget law	The budget calendar and procedures allow the National Assembly enough time for a meaningful budget debate but the budget does not include detailed estimates of revenue sources or medium-term frameworks to guide the debate.	**C+**

PI-28: Legislative scrutiny of external audit reports

Dimensions to be assessed: (i) timeliness of examination of audit reports by the legislature; (ii) extent of hearing on key findings undertaken by the legislature; and (iii) issuance of recommended actions by the legislature and implementation by the Executive.

71. Apart from contributing to the drafting of a legal base for the establishment of an SAI, the National Assembly has launched a public tender for a firm to undertake the audit of the 2002, 2003 and 2004 consolidated accounts of the Republic. Despite the fact that provisions in the 2002 BSL allowed for an audit of the consolidated financial statements to be contracted out to an audit firm, the tender for the independent external audit was not initiated until 2005. An inconclusive tender for the external audit of the 2002 and 2003 government accounts was launched by the MOF on February 8, 2005. The selection was subsequently left to the National Assembly on the recommendation of a working group appointed by the Assembly's Finance Committee on September 13, 2005. On February 7, 2006 the National Assembly's Finance Committee endorsed the recommendation of its working group to let the Secretary of the Assembly initiate the tender for the audit of the consolidated Government accounts for 2002-2004. The tender for the audit of the 2005

[57] See information provided under PI-16 concerning budget revisions.

accounts has not yet been launched. The absence of an external audit of the consolidated government accounts means that the score for the indicator "legislative scrutiny of external audit reports" is set at **D**.[58]

INDICATOR	BRIEF EXPLANATION	SCORE
PI-28: Legislative scrutiny of external audit reports.	No external audit of the most recent years of the consolidated government accounts has taken place.	**D**

E. DONOR PRACTICES

Donor Indicator (DI) 1: Predictability of Direct Budget Support

Dimensions to be assessed: (i) annual deviation of actual budget support from the forecast provided by the donor agencies at least 6 weeks prior to the government submitting its budget proposals to the legislature; and (ii) in-year timeliness of donor disbursements

72. Three of the PEFA indicators relate directly to the use of beneficiary countries' own PFM systems for donor support. The first Donor Indicator (DI-1) concerns predictability of direct budget support. In recent years, only the World Bank has provided budget support to Serbia in the form of structural adjustment operations and, in 2005, Development Policy Lending. Due to the many problems in fulfilling on time all conditionalities, it has not been possible to make firm quarterly disbursement estimates before the beginning of the fiscal year for the last three years and budget support has fallen short of forecasts by more than 15 percent. Consequently the indicator is measured to be **D**.

INDICATOR	BRIEF EXPLANATION	SCORE
DI-1: Predictability of Direct Budget Support	Due to difficulties in timing the meeting of conditionality, it has not been possible to make firm quarterly disbursement estimates for the proceeds of budget support.	**D**

[58] PI-26 is measured through the assessment of these dimensions: (i) Scope/nature of audit performed (including. adherence to auditing standards); (ii) Timeliness of submission of audit reports to the legislature; and (iii) Evidence to follow up on audit recommendations. PI-28 is measured through the assessment of these three dimensions: (i) Timeliness of examinations of audit reports by the legislature (for reports received within the last three years); (ii) Extent of hearings on key findings undertaken by the legislature; and (iii) Issuance of recommended actions by the legislature and implementation by the Executive.

DI-2: Financial information provided by donors for budgeting and reporting on project and program aid

Dimensions to be assessed: (i) completeness and timeliness of budget estimates by donors for project support; and (ii) frequency and coverage of reporting by donors on actual donor flows for project support.

73. Based on the unaudited financial statements comparing budget outturn and budgets, it is estimated that, in terms of submission of budgets on donor flows, at least half of the donors provide complete budget estimates for the coming fiscal year no less than three months prior its start. The dimension (i) is therefore rated **C**. Furthermore, it is estimated that quarterly reports on disbursements of less than 50 percent of the externally financed project estimates in the budget are provided by donors within two months of end-of-quarter, giving a rating of dimension (ii) at **D**. On this basis, the indicator is set at **D+**. It should be noted however that the ISDACON[59] website provides an overview of disbursed and allocated funds per donor and project. Also, the unpublished annual financial statements for 2004 and 2005 include budget and outturn for all loans and at least 50 percent of grants.

INDICATOR	BRIEF EXPLANATION	SCORE
DI-2: Financial information provided by donors for budgeting and reporting on project and program aid	At least half of the donors provide complete budget estimates for the coming fiscal year three months prior to its start. Quarterly reports on disbursements of less than 50 percent of the externally financed project estimates in the budget are provided by donors within two moth of end-of-quarter.	**D+**

DI-3: Proportion of aid that is managed by use of national procedures

Dimension to be assessed: overall portion of aid funds to the central government that are managed through national procedures

[59] The Inter-Sectoral Development and Aid Coordination Network (ISDACON) was formally established through the Government Decision from September 2003, as the network of units for international cooperation with the mandate to proactively program, coordinate, manage and monitor international assistance in the Republic of Serbia. ISDACON falls under the responsibility of the Ministry of Economic International Relations. The scope of work of the ISDACON Network was defined based on the activities and tasks already performed by the Development Aid Coordination Unit and line Ministries. The purpose of ISDACON is to facilitate collection and disbursement of data within the Government of Serbia. It is expected to facilitate policy-making within the Government of Serbia from the aspect of international assistance and to promote proactive planning in order to ensure that aid complements the budget planning process and reforms towards EU integration and PRSP implementation.

74. The PEFA indicator on proportion of aid managed by the use of national procedures (DI-3) is measured as the overall proportion of aid funds to central government that are managed through national procedures. Due to the lack of confidence in the fiduciary system in Serbia, national procedures are not accepted by donors and the indicator is set at **D**.

INDICATOR	BRIEF EXPLANATION	SCORE
DI-3: Proportion of aid that is managed by use of national procedures	Due to the lack of confidence in the fiduciary system in Serbia, national procedures are generally not used by donors.	**D**

CHAPTER 4: GOVERNMENT REFORM PROCESS

Recent and on-going reforms

75. **Reform in the area of Public Financial Management is carried out under the umbrella of broader government strategies such as the Stabilization and Association Process and the Poverty Reduction Strategy.** The Government of Serbia's reform programs are embedded in two complementary strategies: the Stabilization and Association Process (SAP), and the Poverty Reduction Strategy (PRS). As part of the broad SAP agenda the Government is envisaging: (i) reforming the public administration (including the civil service pay system); (ii) preparing a comprehensive anti-corruption strategy; (iii) implementing a tax reform package (including VAT); (iv) establishing an effective public procurement regime; and (v) developing reliable statistics. As part of the PRS, the Government envisages improving costing, establishing clear linkages with the republics' budget processes and strengthening the framework for implementing the PRS.

76. **A number of major donors provide support for reforms in Public Expenditure and Financial Management and are making efforts to coordinate their support.** Support for reforms has come from EAR and the Untied Kingdom's Department for International Development (DFID), the United States' Treasury and the DFID on public expenditure management and public administrative reform, and USAID on pension reform. Also, the Norwegian Ministry of Foreign Affairs is supporting the MOF budget department in preparing for the introduction of program classification. Furthermore, Norwegian Ministry of Foreign Affairs is supporting the "Joint project" where MOF is participating as one of the central institutions. This project is aimed at improving implementation of reforms through building systems and capacity for integrated planning, budgeting, monitoring and reporting across the Government of Serbia.

77. **Several key reform activities in the field of public financial management and financial accountability have been funded by the EU via the EAR**. The funds provided for capacity building in core PFM areas totaled EUR 21 million in 2004; EUR 16.2 million in 2003, and EUR 7 million in 2002[60]. The funded projects and commitments made have been aimed at supporting the development of the MTS, financial control systems including internal audit, and assistance in the development of a SAI.

78. **USAID and the US Treasury have also been providing considerable amounts of assistance for institution building, including for PFM.** A jointly conceived USAID-US Treasury Tax Policy and Administrative Reform project is ongoing. The project aims to improve collections, audit, taxpayer services, information technology (IT) and other areas of tax policy and administrative reform. Progress is reportedly satisfactory, and has accelerated with the introduction of a VAT in 2004 or 2005. USAID has commenced work on broad fiscal reform (including pension), which is deemed critical to keeping the

[60] These amounts reflect the sums appropriated and not the sums disbursed.

social benefits systems afloat. The proposed annual obligation for the entire USAID program for Economic Reform, Restructuring and Policy in Serbia is US$17 million for each of the years 2004 and 2005. The US Treasury has a resident advisor in Belgrade, who has assisted the MOF in modernizing the budget preparation process. Among other things, the Advisor and her team contributed to the development of the budget memorandum for 2004. They were, however, not involved in the Budget Memorandum preparation for 2005.

79. **While important and far-reaching reforms in Treasury management and internal control are ongoing, strong strategic leadership of the overall PFM reform effort is needed**. Progress has been made through the revisions of the Budget Systems Law and the integration of the Public Payments Agency (PPA) into the Treasury. A new comprehensive Treasury System, the MTS, is in preparation and will replace the Interim Treasury Ledger System (ITLS) currently in place. According to the project's technical specifications, the implementation of the MTS will be completed at the end of 2007. The MTS will integrate all Budget Beneficiaries (BBs) into the TSA and enable them to access accounting and transaction information on-line. DBBs will be able to submit commitment and payment orders online, while IBBs will do so via a PPA branch office. In addition to the MTS, the MOF intends to move towards a program-based budget approach and reinforce the multi-year expenditure framework. Considerable investment and efforts are currently being lent to develop Public Internal Financial Control and internal audit in line with EU practices. All of the above reform activities are strongly supported by the donor community, including the EAR, DFID, Norwegian Ministry of Foreign Affairs, IMF and the World Bank. However, the overall coordination and management of the reforms appear to be missing as the individual reform components seem to be owned and driven by individual technical project counterparts in the Ministry of Finance rather that the Ministry of Finance as such. This creates a risk for overlapping and uncoordinated technical solutions.

Institutional factors supporting reform planning and implementation

80. **There have been significant problems in starting some of the PFM reform projects.** Examples include the funding appropriated by the EAR in 2002 for establishing an SAI and building capacity at the Public Procurement Office. As stated in the reports from the EAR, it was not possible to start the projects due to weak absorption capacity in key institutions, such as the MOF.

81. **Although progress has been slow, the most recent government initiatives in PFM reform have been encouraging.** This includes making budget execution data publicly available; modernizing the Treasury and internal control systems, adopting a law for the establishment of a Supreme Audit Institution and seeking and obtaining parliamentary approval of the appointment of an external auditor for the 2002, 2003, 2004 and 2005 accounts. The delays in appointment of the external auditor can at least partly be explained by the delays inherent in the democratic process that has required the National Assembly's active and legitimate engagement in authorizing the tender process.

82. **Recent World Bank diagnostics point to the need to develop an integrated reform management approach in Serbia, which basically reflects the consensus**

between the Government and the Serbian donor community. The draft 2005 update of the Public Expenditure and Institutional Review (PEIR) argues that management weaknesses are reflected in: (i) disjoints in the reform program; (ii) coordination problems within government and with donors working on various projects; and (iii) continued difficulty in accessing and retaining the talent needed to implement and sustain this aggressive reform agenda. These weaknesses have different levels of severity across reform types, with some reform entities recently initiating good communications with others. An integrated approach to thinking about reforms or ensuring the appropriate sequencing of steps across the expenditure management system is needed. This assessment is generally shared by the main donors, including the EAR, DFID, Norwegian Ministry of Foreign Affairs and IMF.

83. **The Government has committed itself to prior actions that will facilitate public expenditure and financial management reforms.** It is anticipated that the Government will take concrete steps to improve the overall coordination of Public Expenditure Management (PEM) reform, including: (i) assigning a senior MOF official as Champion for PEM reform; and (ii) developing an integrated vision document covering all relevant PEM reform areas, providing implementation plans for a three-year period, with time-bound implementation and performance milestones to facilitate monitoring. Concrete reform initiatives are expected to be aimed at: (a) moving towards a program-based, multi-annual Government budget approach; (b) modernizing the Treasury (including payroll) system; and (c) establishing a Supreme Audit Institution. The Government of Serbia has received a Policy and Human Resource Development (PHRD) grant from the Government of Japan. The grant has so far financed a consultant who has drafted a report titled “Developing Integrated Vision of Public Financial Management Reforms”. The report is expected to serve as a foundation for the development of a government-led PFM reform vision. In support of this process, the PFMA provides a baseline assessment that can be used to measure and currently monitor PEM and PFM reform progress.

ANNEX I: PEFA SCORING METHODOLOGY

Most of the indicators have a number of dimensions linked to the subject of the indicator and each of these dimensions must be assessed separately. The overall score for an indicator is then based on the assessments for the individual dimensions of the indicator. Combining the scores for dimensions into the overall score for the indicator is done by Scoring Method 1 (M1) for some indicators and Scoring Method 2 (M2) for others[61]. It is specified in the indicator guidance for each indicator what methodology should be used.

Method 1 (M1) is used for all single dimensional indicators and for multi-dimensional indicators where poor performance on one dimension of the indicator is likely to undermine the impact of good performance on other dimensions of the same indicator (in other words, by the weakest link in the connected dimensions of the indicator). For indicators with 2 or more dimensions, the steps in determining the overall or aggregate indicator score are as follows:

- Each dimension is initially assessed separately and given a score.
- Combine the scores for the individual dimensions by choosing the lowest score given for any dimension.
- A '+' should be added, where any of the other dimensions are scoring higher (Note: It is NOT possible to choose the score for one of the higher scoring dimensions and add a '-' for any lower scoring dimensions. And it is NOT possible to add a '+' to the score of an indicator with only one listed dimension).

Method 2 (M2) is based on averaging the scores for individual dimensions of an indicator. It is prescribed for selected multi-dimensional indicators, where a low score on one dimension of the indicator does not necessarily undermine the impact of a high score on another dimension of the same indicator. Though the dimensions all fall within the same area of the PFM system, progress on individual dimensions can be made independent of the others and without logically having to follow any particular sequence. The steps in determining the overall or aggregate indicator score are as follows:

- For each dimension, assess what standard has been reached on the 4-point calibration scale (as for M1).
- Go to the Conversion Table for Scoring Method M2 (below) and find the appropriate section of the table (2, 3 or 4 dimensional indicators).
- Identify the line in the table that matches the combination of scores that has been given to the dimensions of the indicator (the order of the dimensional scores is immaterial),
- Pick the corresponding overall score for the indicator.

[61] M1 is used for the scoring of the following indicators: PI-1 – PI-7; PI-9 –PI-10; PI-15; PI-16; PI-18; PI-20; PI-21; PI-23 – PI-28; DI-1 – DI-3. M2 is used for the scoring of: PI-8; PI-11 – PI-14; PI-17; PI-19; PI-22. For details see PEFA methodology on: http://www.pefa.org/about_test.htm

The Conversion Table applies to all indicators using M2 scoring methodology only and cannot be used for indicators using M1, as that would result in an incorrect score. The Conversion Table should NOT be used to aggregate scores across all or sub-sets of indicators, since the table was not designed for that purpose. In general, the performance indicator set has not been designed for aggregation, and therefore, no aggregation methodology has been developed.

PEFA - PFM Performance Measurement Framework, June 2005.
Conversion Table for Scoring Method M2

Scores for individual dim.			Overall score M2
2-dimensional indicators			
D	D		D
D	C		D+
D	B		C
D	A		C+
C	C		C
C	B		C+
C	A		B
B	B		B
B	A		B+
A	A		A
3-dimensional indicators			
D	D	D	D
D	D	C	D+
D	D	B	D+
D	D	A	C
D	C	C	D+
D	C	B	C
D	C	A	C+
D	B	B	C+
D	B	A	B
D	A	A	B
C	C	C	C
C	C	B	C+
C	C	A	B
C	B	B	B
C	B	A	B
C	A	A	B+
B	B	B	B
B	B	A	B+
B	A	A	A
A	A	A	A

Note: It is of no importance in which order the dimensions in an indicator are assigned the individual scores

Scores for individual dim.				Overall score M2
4-dimensional indicators				
D	D	D	D	D
D	D	D	C	D
D	D	D	B	D+
D	D	D	A	D+
D	D	C	C	D+
D	D	C	B	D+
D	D	C	A	C
D	D	B	B	C
D	D	B	A	C+
D	D	A	A	C+
D	C	C	C	D+
D	C	C	B	C
D	C	C	A	C+
D	C	B	B	C+
D	C	B	A	C+
D	C	A	A	B
D	B	B	B	C+
D	B	B	A	B
D	B	A	A	B
D	A	A	A	B+
C	C	C	C	C
C	C	C	B	C+
C	C	C	A	C+
C	C	B	B	C+
C	C	B	A	B
C	C	A	A	B
C	B	B	B	B
C	B	B	A	B
C	B	A	A	B+
C	A	A	A	B+
B	B	B	B	B
B	B	B	A	B+
B	B	A	A	B+
B	A	A	A	A
A	A	A	A	A

ANNEX II: KEY REFERENCES

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ANNEX III: UPDATE OF 2002 CFAA AND CPAR RECOMMENDATIONS

A. Status of Implementation of 2002 CFAA recommendations

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
1. PUBLIC SECTOR: BUDGET MANAGEMENT			
1.1 Planning & Budget Preparation			
Financial Planning	Quality of planning was generally poor. Multi-year financial planning is not developed. Insufficient linkage between government policies and budgetary resource allocations. The new Budget System Law could, in the short term, improve the budget process.	The MOF develop a strategic budget framework: (a) design the medium-term macro-fiscal framework; and (b) conduct an analysis of cross-cutting issues, such as the budgetary impact of planned revenue policy measures, debt servicing, the balance between wage and non-wage allocations, and government decentralization [ST] **The MOF develop a strategic budget framework: (a) prepare sector expenditure strategies; and (b) formulate sector expenditure plans [MT].**	As required under the Budget Systems Law (BSL) significant improvements were made in preparation of the 2004, 2005 and 2006 budgets, for which sector strategies were developed and linked to the budget preparation. Sector strategies were not translated into sector specific expenditure plans.
Budget Coverage	Budget coverage is incomplete. Currently budgets do not include: (i) all revenues and sources of funds (all spending units, grants, donations received by foreign governments); and (ii) all expenditures and uses of funds (including off-budget items and own revenues).	The MOF establish clear and inclusive definitions of general government expenditure. The MOF would implement an all-inclusive consolidated budget framework, comprising central government, local governments, all extra-budgetary funds, own-generated revenues for line ministries, public debt, donor contribution, and direct/indirect transfers to/from public-owned enterprises and the governments [ST].	The implementation of the BSL has provided for the regulation of the planning, preparation and enacting of the budgets of local government into the budget process in line with central government principles. It has also ensured the integration of the main EBFs into the general government budget process and made it possible to identify donor contributions to individual DBBs and transfers to publicly owned enterprises. Finally, it has provided for the inclusion in the budget of an estimate of the total amount of borrowing and a summary of anticipated proceeds from foreign and domestic borrowing.

[62] Recommendations that have not been implemented or only partially implemented are marked with bold text. ST = Recommendation to be implemented in the Short term; MT = Recommendation to be implemented in the Medium Term

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
Institutional development	Budget management functions in the MOF are not separated; staff is inadequate, insufficiently trained. Insufficient information and guidelines to prepare meaningful budgets.	The MOF establish a strong fiscal analysis unit to **provide services such as rigorous forecasts, revenue estimation and tracking on a monthly basis, including consolidated non-financial public sector accounts and off-budget social funds** [ST].	The MOF has established a Fiscal Analysis and Macroeconomic Department in an effort to strengthen the analytical capacity of the Ministry. The introduction of a Value Added Tax (VAT) and the Law on public revenues and taxes has changed the basis for doing revenue estimations significantly compared to 2002. The MOF complain that it is hard to attract qualified staff to key budget analysis functions because of the uncompetitive salary levels offered by the Ministry. There have been a number of training activities undertaken by budget analysis staff, mostly provided by foreign donors such as the US Treasury. Sustainable training facilities are limited to the cooperation with the Belgrade Faculty of Law and the University Department for Economists, from where the Ministry recruits most of its academic staff. Based on the above and statements made by senior staff in the Ministry, administrative capacity in the MOF appears to be at a level comparable to the one reported in the 2002 CFAA.
Procedures and timetable	The new budget law sets out a new calendar and prescribes new budget procedures.	In accordance with the new budget law, the MOF is to implement the new budget calendar increasing the time allocated to planning and budget cycle, and also increasing the time allocated for the scrutiny and debate of the budget, in accordance with the new budget law [ST].	As recommended by the CFAA, and in accordance with the provisions of the BSL, a new budget calendar has been introduced, which allocates more time to budget planning, cycle, scrutiny and debate. Interviews with the MOF and the heads of financial services of DBBs suggested that the BSL timetable is generally respected.
1.2 Budget Execution			
Strengthen capacity for budget execution in direct spending units (DBBs).	Budget execution in the past decade was very ineffective. DBBs do not have intra-year spending plans, nor are the submitted plans consolidated to give an overall government-spending plan.	All direct budget beneficiaries prepare quarterly financial plans satisfactory to the MOF [ST]. Each spending unit to appoint a Chief Financial Officer (CFO) approved by the MOF and accountable to MOF for the execution of the budget [MT].	The DBBs have to respect monthly and quarterly expenditure limits set by the MOF on the basis of plans submitted by DBBs and availability of funds. In the DBBs and EBF reviewed, there were different solutions to ensure proper budget execution controls. One of the DBBs required commitments and payments to be

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
			verified by an appointed financial controller, whereas the Head of another DBB was required to co-sign commitment and payment requests with the Head of the DBB (in this case a Minister). In both cases, the financial controller/co-signatory is pre-approved by the MOF.
Expenditure Management – Lack of commitment control	The present system focuses on cash controls and is unable to control commitments. The new OBL introduces the concept of commitment accounting.	Introduce reliable tracking of expenditures (including establishing an accurate inventory of arrears) in all ministries [ST]. Introduction of commitment accounting, which would allow optimization of cash management and tracking of arrears. The MOF should establish a commitment control system (based on the new treasury system) to prevent and/or control the creation of new arrears [ST]. Over the medium term, a switch to a modified accrual accounting system could be considered [MT].	The consolidation of all DBB accounts in the ITLS and the statutory procedures for authorizing commitments and payments has improved expenditure tracking in all ministries. It has also facilitated a more accurate recording of arrears. Under the Extended Arrangement with the IMF, data on the end-period stocks of arrears for the previous quarter are supplied to the IMF by the MOF. Commitment controls and accounting has been introduced via the ITLS but a current practice of submitting commitment and payment requests simultaneously limits the information value of commitment data. Some accrual information is available via the ITLS.
Parliamentary Oversight	Public Accounts Committee has been established but is not yet functional. A chairman has been appointed but the committee has neither a proper structure and resources, nor a clear mandate.	**Parliamentary oversight committee is strengthened**. The budget oversight functions are separated from other legislative oversight functions [MT].	There is no Public Accounts Committee. Both the Finance Committee and the Legislation Committee of the National Assembly oversees government finances. Also, a sub-committee to the Finance committee has been established to assist in the preparation of a legal basis for the establishment of a Supreme Audit Institution.
2. PUBLIC SECTOR: PAYMENTS, CASH MANAGEMENT AND TREASURY			
2.1 Cash Management			
Strengthening institutional capacity	Limited capacity in the MOF responsible for effective cash management.	A cash and debt management function should be established within the newly-formed Treasury department to implement improved cash management procedures [ST].	Organizational units responsible for cash and debt management have been established inside the new Treasury department of the MOF.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
Inadequate cash management	Cash management is weak and inefficient presently. Although, in practice, cash flows are monitored on a daily basis, to ensure the availability of funds to meet the major regular payments, other transfer requests are considered each day and priority requests approved. This daily triage can imply that urgent items early in a week can displace more important items later in the week.	**The MOF introduce an effective cash management system (based on realistic revenue and expenditure schedules) to replace the present cash release mechanisms at all levels of governments [ST].** **The MOF should introduce a weekly triage replacing the daily triage for non-scheduled payments [ST].** In the medium term, the new budget laws would enable the MOF to improve cash management through the establishment of a Treasury Single Account (TSA) [MT].	The cash management does provide some projections of cash needs but the traditional cash rationing and release mechanism based on actual revenues collected seem to prevail. Weekly triages have not replaced daily triages. A TSA has been established and integrated all DBBs via the ITLS.
Banking arrangements	The MOF had started abolishing the DBB's accounts in October 2001 but some of the major ministries still have not switched to the new system, and a few ministries are outside the control of the MOF.	The MOF should devise new arrangements for making payments on the closure of DBB accounts, including implementation of an action plan to systematically **close the DBB accounts for those ministries that are still operating their own accounts, preparing an inventory of giro accounts of all budget users,** and establishing policies and procedures to better manage these accounts [ST].	All DBB accounts have now been integrated into the TSA. IBB accounts are still to be integrated but this is planned as part of the MTS project. The Treasury is scheduled to complete a full inventory of all IBB accounts denominated in RSD and foreign currency by the end of 2006.
2.2 Development of modern Treasury System			
Creation of a Treasury system	The government will establish a new treasury, as specified in the new OBL. Treasurer has been appointed. Organization chart has been drafted.	The MOF to adopt a time-bound plan for the implementation of new treasury services to the operation of all spending units and also all social funds [ST]. Finalize organization structure for the new treasury [ST].	A time-bound plan for completing the establishment of a TSA system has been established (the MTS project). A new organization structure for new Treasury has been developed and substantially implemented.
Treasury Single Account)	The Treasury Single Account (TSA) has been opened but does not include all revenues and ministries.	The transfer of accounts of all direct budget beneficiaries and ministries into the Single Treasury Account [ST].	Recommendation fully implemented.
Treasury General Ledger	Lack of a sound computerized accounting system for the new budget classification.	Until the completion of the new treasury system in late 2003, an interim treasury/general ledger is implemented by the MOF to improve its cash management and commitment control, and to provide accurate and reliable budget reports [ST].	An interim system, the ITLS, has been completed and commitment and payment authorization controls have been institutionalized. Data for financial reports to government prepared by the Treasury's accounting department based on data from the PPA.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
		The implementation of the comprehensive computerized accounting system [MT]. Complete full specification of requirements for the full treasury system [ST].	The Treasury has recommended new accounting software to DBBs which meets requirements of the new Decree on Accounting. The software is now being installed by DBBs. Specifications of the requirements for a full TSA system have been drafted.
3. PUBLIC SECTOR: ACCOUNTING AND REPORTING			
3.1 Budget Classification			
Budget Classification	2002 budget was prepared using IMF GFS classification but was not extended to all users.	All budget users financed from the budget are using a standard budget classification [MT].	A standard Chart of Account (COA) has been issued by the MOF is applied by the DBBs and major EBFs. According to the most recent IMF report the new COA is generally consistent with the classifications of the Government Finance Statistics Manual (GFSM) 2001 but not yet fully implemented across government.
3.2 Accounting Standards			
Accounting standards	Lack of appropriate accounting standards for the public sector financial accounting and reporting.	The MOF should adopt a rulebook that regulates the structure, formats and standards of accounting and reporting to be applied to all public sector institutions [ST]. The MOF review the appropriateness of the use of NAS in government accounting and reporting. In the meantime, IFAC-PSC Exposure Draft 9 "Financial Reporting Under the Cash Basis of Accounting" should be adopted [MT].	The MOF has issued a Decree on Budget Accounting, and a By-Law on Standard Classification Scope and Account (OG No. 92/2002 and 64/2003) complying with the standard COA and the budget classification. The Decree and the By-law set out an appropriate framework for public sector accounting requiring that the basis for budget accounting is cash, and budget execution reports are being prepared in accordance with IPSAS Cash. The MOF's Accounting and Auditing Division is reviewing the appropriateness of the use of National Accounting Standards in Government reporting. No deadline has been set for a Government decision on whether or not to apply NAS.
3.3 Accounting system			
Enhancing institutional capacity in accounting policy	Presently the MOF does not have a full picture of all financial transactions, because the ZOP and the MSA, which had clear but limited reporting responsibilities to the line ministries, are	The MOF should establish an accounting policy and methodology function in the Treasury Department to carry out the necessary methodological strategic thinking and to prepare the detailed accounting policies and	The MOF has established an Accounting and Auditing policy Division which provides current policy advice to the Government on matters pertaining to auditing and accounting.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
and methodology	precluded full reporting to the MOF. Bookkeeping is cash-based with some rudimentary elements of commitment tracking.	procedures necessary for the implementation of the new budget law and required accounting standards [ST].	
Enhancing centralized accounting function	The accounting system suffers from a lack of centralized accounting function capable to provide standardized polices, procedures and methodologies on sound accounting and high-quality reporting.	The MOF create a centralized accounting function within the Treasury Department, whose functions would include: (a) a front-office accounting unit that would deal directly with the financial management units of the Direct Budget beneficiaries (DBBs), processing the commitment and payment requests; (b) a back-office accounting unit that would prepare accounts, manage the ledger system and provide access to regular daily information to other users in the MOF; (c) **a payroll office for DBBs' salaries**; and (d) coordination with MSA and ZOP [ST].	Today the Treasury consists of five units covering the following areas: (i) cash management, banking operations and payments; (ii) debt management; (iii) Accounting and reporting; (iv) Accounting services and expenditure control; and (v) Normative-Legal and studious-analytical procedures. A payroll office has not been established and, as payroll is still processed and recorded by the MSA for a number of DBBs, interfaces have been established between the Treasury system and the PPA (responsible for ZOP's accounting and payment function for DBBs). The Treasury relies on the PPA's data for financial reporting purposes.
3.4 Budget Reporting			
Fiscal reporting	The Treasury system being established under the OBL provides for regular fiscal reporting. Although monthly reports are available, the quality of these reports is still weak and inadequate. A comprehensive computerized system will be established, adevelopment phase is planned to finish by July 2002 and implementation will last well into 2003.	Timely and accurate reporting on budget execution be prepared by the governments and presented to the legislature for discussion on a regularly basis, at least quarterly. The new Treasury is to generate monthly or quarterly budget execution reports and provide these to the MOF management team, and prepare monthly or quarterly summaries of budget execution to the Cabinet [ST].	Monthly and quarterly budget execution reports are submitted by DBBs to the MOF in accordance with the standard formats prescribed by the relevant regulations issued by the MOF. Monthly and quarterly summary reports with expenditure breakdowns to sub-category level are prepared by the Treasury. Reports on cash flows and closing balances as well as monthly revenue reports are also available from the Treasury's accounting system. Implementation has not happened as fast as anticipated in the 2002 CFAA.
Budget reports	The new budget law and the new treasury introduce new budget reports.	The MOF introduce more meaningful budget execution reports, including: (a) a monthly summary report providing expenditure breakdown up to sub-category level for all transactions; (b) a quarterly report providing details of items and selected sub-items of spending; (c) a monthly report on cash flows and closing balances; and (d) monthly reports on revenues [ST].	Recommendation have been substantially implemented. See above. However, budget execution reports are not made available to the public.
Accountability for budget reporting	Prior to the introduction of the new budget law, there was no accountability for budget reporting	Each level of government is made accountable for the comprehensive and reliable budget reporting, including monthly, half-yearly, and **annual consolidated budget**	Each level of Government is required to submit comprehensive and reliable budget reports on at least a

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
	by budget holders or budget beneficiaries.	**execution reports to parliament** [MT].	monthly, half-yearly and annual basis. At the level of the Republican budget the annual consolidated financial statements for fiscal years 2003 and 2004 have been compiled and prepared by the Treasury with data-input from the PAA, but the statements have not yet been presented to the Government or the National Assembly. The statutory deadline for submitting the final consolidated statement to the National Assembly is June 1 in the year following the fiscal year.
3.5 Public Debt Management			
Public debt management	Very limited capacity to manage public debt.	Establish a cash and debt management function in the Treasury, with staff being hired and training being organized [ST].	A debt management unit has been established in the Treasury but modern debt management practices are still to be developed.
Debt management system	Public debt has not been included in the Republican budget. There is a need to establish instruments of control and to carry out an independent audit of the financial positions and liquid assets of the public sector enterprises that are claiming to be incapable of servicing the debt obligations.	The MOF to finalize policies and procedures for public debt management [ST]. The MOF implement a new public debt management system, for the accounting of all public debt, which will be integrated with the new treasury system [MT].	Major debt portfolios were included in the 2004, 2005 and 2006 budgets. The budget memoranda for 2004, 2005 and 2006 laid down broad policies. Detailed procedures for debt management are still not developed.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
4. PUBLIC SECTOR: FINANCIAL CONTROL, INTERNAL AND EXTERNAL AUDIT			
4.1 Financial Controls			
Poor financial controls	The existing financial control functions have been weak – there are neither satisfactory ex-ante, nor ex-post, control functions – and this need strengthening. Elements of financial control have been carried out by ZOPs, by internal controllers within some line ministries, by the Mutual Services Agency, and by the MOF. These controls were limited to basic documentary checks of the accounting and reporting of spending units.	The ex-ante procedures to check the legality and amounts of transactions at the expenditure's commitment stage are reinforced to avoid overspending and that ex-post controls are introduced to verify the correctness and appropriateness of transactions, and their proper recording [ST]. The MOF (the Treasury) should establish and institutionalize internal controls, by strengthening existing policies, procedures, rules and internal regulations across budget beneficiaries and in all phases of the public finance management (covering budget planning, preparation, execution and reporting), and supported by compliance checks by the budget inspectorates or internal audit departments [ST].	The roles of the DBB financial services and the clear assignment of responsibilities for management and internal control systems to the heads of DBBs, have facilitated more effective controls. The responsibilities for ex-ante financial controls are formally assigned to individuals in the DBBs by the MOF. There are some variations between different DBBs in how the BSL is being applied, for instance, whether the Head of financial services or another individual has the ex-ante control responsibility. There are also variations when it comes to the extent to which detailed written procedures have been elaborated on the basis of the BSL and other relevant regulations.
4.2 Internal Audit			
Budget Inspectorate	There is currently no Internal Audit (IA) function operating (in the Western sense). The closest parallel is the work done by the Budget Inspectorate (BI), which carries out compliance work, to check whether internal control procedures are being properly followed. BI performed a number of inspections in 2001. BI has an inadequate mandate, is insufficiently staffed, and is poorly equipped to carry out its duties efficiently and effectively.	**The budget inspectorate could be strengthened** and its experiences could be used to build the internal audit functions [ST].	The Budget Inspectorate continues to have very few staff – a total of 17. Whereas an Internal Audit Unit (IAU) has been established in the MOF and in some of the major DBBs and EBFs, modern internal audit practices are still in the process of being developed. Internal audit guidelines in line with internationally recognized standards have been drafted and training has been carried out under a comprehensive and well conceived EAR funded project. The Budget Inspectorate and the IAU coordinate their work and training and they report to the same Assistant Minister who reports to the Minister.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
Development of internal audit	The OBL provides for the establishment of a Budgetary Inspection and Audit Service (BIAS), and equivalent bodies at the local level. Detailed guidance, through detailed regulations, on how Internal Audit will operate is needed and to be prescribed by the Minister of Finance. No staff have yet been allocated within the Ministry of Finance to do IA work. Support for the development of IA in Serbia will be provided by the European Agency for Reconstruction (EAR), due to start in 2002.	The MOF is to establish and adequately staff the Internal Audit Department, outline its functions, and adopt its procedures and the annual audit plan for 2003 [ST]. As a priority, an action plan setting out milestones for developing Internal Audit Departments should be developed [ST]. As a first step, the MOF should appoint an Assistant Minister to head the internal audit department, who should not have any other operational responsibilities within the MOF or any bodies falling within internal audit's remit [ST]. **To provide overall independence, the Serbian government should ensure that adequate and sustainable financing is made available to enable the internal audit department to become established and carry out their responsibilities, based on the annual work plan** [ST]. **In the longer term, it may be desirable to set up internal audit departments within individual line ministries or other spending units, at least for those with larger budgets** [MT].	The IAU has been established in the MOF. The heads of the IAU and the Budget Inspectorate both report to an Assistant Minister which reports to the Minister. With only 11 staff the IAU is not appropriately staffed to fulfill its current mandate as a government wide audit function. It is, however, a good basis for supporting the rollout of a government-wide, decentralized internal audit system. A 2004 Decree on "direct budget users that organize special internal audit body and on common criteria for internal audit organization and procedure of direct budget users and mandatory social insurance organizations" requires the establishment of internal audit units in 18 DBBs and in the major EBFs (the mandatory social insurance organizations). A EUR 7 M. The Public Finance project funded by the EAR supports the development of internal audit.
4.3 External Audit			
Selection of a suitable Supreme Audit Institution (SAI) model	The National Assembly, with assistance from the United Nations Development Program (UNDP) Program for Accountability and Transparency (PACT), established in 2001 a Working Group to consider the way forward for the creation and establishment of an SAI. The Working Group visited the SAIs of Slovenia, Germany and France but it did not include a pure Westminster SAI model in its study tour activities.	Finalize a study on the suitability of different models for external audit for Serbia, as a basis for future choice of an external audit model. The study should include a visit to a pure Westminster SAI model [ST]. Select a model which would be relevant and applicable to the Serbia [ST]. **The government should immediately establish a provisional, broad timetable to take forward the development of a SAI [ST].**	A feasibility study has been carried out and an SAI law has been drafted by a sub-committee to the Finance Committee of the National Assembly. The law has been adopted by the National Assembly. A timetable for the establishment of an SAI has not been presented to the public or to the donor community.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
Establishment and development of SAI	There is currently no functioning SAI. The European Agency for Reconstruction (EAR) will provide support for the establishment and development of a Supreme Audit Institution that meets international and European Union auditing standards.	Finalize constitutional and legal framework for the operation of an SAI, that should comply with the broad principles espoused by the International Organization of Supreme Audit Institutions (INTOSAI) in the Lima Declaration of 1977 and republished in 1998 [ST]. **Development of SAI meeting international standards, including recruitment and training of staff, development of standards and methodology, and adequate budget allocation [MT].** **To provide overall independence, the Serbian Parliament should ensure that adequate and sustainable financing is made available for SAI activities, with financing tied to an annual work plan and including the necessary investments in infrastructure and information technology [MT].**	The SAI law is in line with the INTOSAI Auditing Standards and the Lima Declaration. The Government has taken no concrete action to establish the SAI.
External audit of final budget accounts	Presently the final budget accounts are not being audited	**Until the establishment of a functioning supreme audit institution (SAI), the Government should start contracting external (private and independent) auditors to audit the final accounts (including both revenue and expenditure) for the Budget 2001 [ST].**	No external audit firm has been contracted for the years 2002, 2003, 2004 and 2005.
4.4 Anti-Corruption Initiatives			
Corruption	According to a public opinion survey on corruption carried out in January 2001, citizens of Serbia believe that the phenomenon of corruption is one of the most serious problems facing the Serbian society today. The Serbian Government is implementing a multi-pronged strategy for combating corruption.	Strengthening of the newly established special Commission for Fighting against Corruption and strengthening of the Council for Fighting Corruption and Crime [ST]. Strengthening of collaborative partnerships with civil society, including greater consultation, participation and scrutiny in a common cross-cutting anti-corruption program and legislation by NGOs [MT]. Publication of decisions involving use of public finances (including procurement decisions) in the Official Gazette and, possibly, the media [MT].	The Anti-Corruption Council has been a very active and very visible institution in the fight against corruption. It is recognized as an independent institution operating with a high degree of integrity. It has sponsored and published a great number of reports and studies on corruption-engaged Government officials in a dialog on how to prevent official corruption. It has been one of the lead promoters of a Law on Conflicts of Interest currently pending in the National Assembly.

Key Area in 2002 CFAA	Status in 2002 CFAA	Recommendations in 2002 CFAA[62]	Current status
Money laundering and financial crimes	The incidence of money laundering and financial crime is a serious concern.	Develop a comprehensive plan (**including passing anti-money laundering legislation**) to confront its criminal environment and the associated problems of money laundering [ST].	The Administration for the Prevention of Money-Laundering (APML) has been established. The entity functions as a Financial Intelligence Unit (FIU) and has had some success in confronting high level financial fraud. In 2004, two cases investigated by the unit led to high profile court cases. In 2005, 15 cases were investigated but so far none has led to court cases. A new anti-money laundering law which is aimed at strengthening and align the APML's practices with the principles applied by FIUs internationally is pending adoption by the National Assembly.

B. Status of Implementation of 2002 CPAR recommendations

Key Area in 2002 CPAR	Status in 2002 CPAR	Recommendations in 2002 CPAR	Current status (End 2005)	Outstanding or new recommendations in 2005
Overall Assessment	Procurement has, until recently, been a neglected function. Yet public procurement accounts for a significant percentage of public expenditure (9.5 percent of GDP). Government can realize savings of as much as 20 percent of total value through competitive public procurement. Public procurement environment is high risk.	Details given below.	The main conclusion of the 2002 CPAR that the environment for conducting public procurement in Serbia was associated with "high" risk, has been changed to "significant". According to a 2003 Report by the Public Procurement Office, higher savings were achieved in Open Procedures (16 percent) and lowest in the Negotiated Procedures (2 percent). According to the same 2003 report before the PPL was enacted, the average number of bidders per contract was around 3, which has grown to 7.5 in 2002 and 8.5 in 2003.	Details given below.
Legislative Reforms in Procurement	There were many gaps and weaknesses in the legal system in the Federation and Serbia. A new draft Public Procurement Law (PPL) was put before the Parliament at the time of completion of the June 2002 CPAR for Federal Republic of Yugoslavia. This draft contained many of the key ingredients for a good public procurement law, but critical deficiencies were identified in the CPAR	Clear procurement rules should be included in the Acts governing the new State Union institutions. Serbia should give priority to enacting an improved Public Procurement Law. The Procurement Law in Serbia should be supported by comprehensive implementing regulations and standard procurement documents.	The new law entered into force in July 4, 2002 contained key ingredients of good public procurement, but still required improvements. The Law on Alterations and Amendments to The PPL entered into force on July 1, 2004. This law streamlined procurement procedures and defined protection of tender's right more precisely. The PPL was altered to allow for publication of all contract awards, allowed award of contract below a threshold even if one tender (which was correct, adequate and acceptable) was received. Also the status, composition and functioning of the Commission for the Protection of Tenderers' Rights (CPTR) was better defined in the modifications.	Comments expressed in CPAR of 2002 to be incorporated in the legal text by an amendment to provide a firmer base for transparency, accountability and competitiveness. Any preferential treatment of bidders should be removed from the legislation as soon as possible.

Key Area in 2002 CPAR	Status in 2002 CPAR	Recommendations in 2002 CPAR	Current status (End 2005)	Outstanding or new recommendations in 2005
			Critical Deficiencies, as pointed out in 2002 CPAR: (i) use of restricted procedure (It should be noticed that according to the PPL , Article 22, the "restricted procedure" is a two-phase competitive bidding with first phase prequalification – akin to open procedure and, in the second phase, all prequalified bidders are invited to submit bids . The purchasing entity must request prior opinion from the PPO to apply restricted procedure.); (ii) widespread use of Negotiated procedures; (iii) lack of transparency in the Selection of Providers of Service; and (iv) reciprocal access - a sort of "club" that excludes bidders from other countries. The introduction of a 20 percent preference for domestic tenderers constitutes a step backward compared to the original content of PPL. In the first quarter of 2003, the PPO introduced secondary legislation on implementation of PPL for keeping record, tender opening, establishing public procurement committees. PPO also issued model public procurement notices, regulation on awarding low value public procurement contracts, model procurement plan, model public procurement contracts and tender documents for goods and services.	The conditions under which the "negotiated" procedure may apply should be reconsidered and better specified in the PPL
Institutions/ Organization for procurement function	The authority and responsibility for conducting procurement are not clearly defined. The capacity to conduct procurement is weak. Untrained, non specialist staff handle procurement, often improperly, which compounds the weaknesses in the	New and stronger regulatory institutions are needed to improve enforcement. A new Public Procurement Law proposes the establishment of a new Public Procurement Office (PPO) reporting directly to the Government. Until the	The Public Procurement Office (PPO) began operating on January 15, 2003 The PPO was set up according to the Law as an independent agency of the Government of Serbia assigned with establishing an economic, efficient and transparent system of public procurement.	The members of CPTR are frequently appointed and dismissed by the Government. Proper regulation should be established to regulate the appointment of CPTR members for its effective functioning.

Key Area in 2002 CPAR	Status in 2002 CPAR	Recommendations in 2002 CPAR	Current status (End 2005)	Outstanding or new recommendations in 2005
	legislation. The rights of the bidder are inadequately protected. Regarding audit, both internal and external controls are weak.	PPO is functional, its function will be discharged by the Mutual Service Agency.	The system of public procurement in Serbia rests on three pillars: the Ministry of Finance and Economy, The PPO and the Commission for the Protection of the Tenderers' right (CPTR). The functioning of the CPTR Committee is closely regulated by its Operational Procedures, which contains issues not covered by the PPL. These are treatment of requests, case allocation, decision making, record maintenance and filing. These Procedures were published on July 27, 2004.	
Training and Capacity Building	A large number of officials require training. A limited Training capacity exists such as in the Faculty of Law.	Comprehensive training activities should be developed. Training should be based on an approved curriculum for public procurement, with a graduated level of complexity. Training initiatives should take place within a planned environment and institutions identified over the long term. The Faculty of Law to deepen the training program on procurement, maybe through twinning relationships. A system of training public officials in procurement to be established. Staff that have successfully completed the required training should be eligible to fill dedicated procurement positions.	According to a 2003 report, the PPO organized 20 major seminars and about 40 smaller gatherings (with more than 3000 participants from both: purchasers entities and bidders) with the aim of explaining the Public Procurement Law and offering advice. Large quantities of detailed training and educational materials have been prepared and disseminated. For example, PPO has published a seminar handbook "Public Procurement-Secondary Legislation- Comments with Examples" .	A comprehensive training strategy should be developed in Serbia. Training should be based on an approved curriculum for public procurement, with graduated levels of complexity. There is a need to make procurement training an on-going, regular activity, and to carry out training of trainers, develop training centers, include procurement into curricula of high education institutions.
Control Environment	Budget law fails to list organizations governed by those laws, thus making it difficult to hold public organizations	Internal audit functions should be established in major spending entities.	Cases of procuring contracts without the corresponding appropriation of funds have been practically eliminated.	Delays in budget approval to be eliminated.

Key Area in 2002 CPAR	**Status in 2002 CPAR**	**Recommendations in 2002 CPAR**	**Current status (End 2005)**	**Outstanding or new recommendations in 2005**
	accountable for the expenditure of budget funds, including that on procurement. The absence of internal and external controls over procurement are very weak and a major gap in the current. Absence of Supreme Audit Institution (SAI) at both federal and republic level means that procurement decisions are not being subject to independent scrutiny.		Frequent delays in the budget approval process cause procurement process to start late in the year. This leads to a situation of applying less competitive procedures and therefore higher costs.	The Government should employ qualified independent auditors to carry out annual audits of procurement. The establishment of the Supreme Audit Institution and the conduct of procurement audit is needed.
Procurement Related Corruption	Procurement-related corruption is a major problem. "Report of Corruption in Serbia" a Center for Liberal – Democratic Studies (CLDS) stated that "all significant decisions and transactions were hidden from public." There are "informal auctions" of Contract. The health sector is regarded as the "epicenter" of corruption. New Government has demonstrated commendable vigor in tackling corruption such as Stability Pact Anti-Corruption Initiatives (SPAI).	Preparation and implementation of draft procurement law is to be expedited as one of a package of five laws aimed at tackling corruption.	Given the point of departure where public procurement practices were poorly regulated, the work done in introducing a proper legal and institutional framework, and establishing procurement practices should be seen as important means in fighting corruption. Close cooperation has been established with both CPTR and the Anti-Corruption Council and budgetary inspection, as well as with the special office of the Minister of Interior (Office for Prevention of Organized Crime, Section for Organized Financial Crime - SOFC), in controlling the largest purchasing entities and contracts.	Enforcement of collaboration with CPTR, the Anti-Corruption Council, budgetary inspection and the special office of the Minister of Interior (Office for Prevention of Organized Crime, Section for Organized Financial Crime - SOFC), in controlling the largest purchasing entities and contracts
Alignment with EU Acquis	The draft Procurement Act relies heavily on The EU Procurement Directives in their formulation of provisions on the treatment of bidders' qualifications (technical, financial and eligibility criteria) and several other aspects. The approach taken by the draft by and large replicates The EU Procurement Directive, although by stating that the Open Procedure is to be used, it exceeds		The Public Procurement Office of Serbia claims in their 2003 Report that Serbia's system of public procurement has been almost completely harmonized with directives issued by the EU, while the institutional framework and capacity for ex-post control need to be developed (this claim needs to be reviewed by the EC). As per Serbian PPO, the key outstanding issues are: (i) the preferential treatment of bidders; and (ii) the appointment of the	The Government to discuss with the EC as to the compliance of its procurement law with the latest consolidated EC Directive of March 31, 2004 (2004/18/EC).

Key Area in 2002 CPAR	Status in 2002 CPAR	Recommendations in 2002 CPAR	Current status (End 2005)	Outstanding or new recommendations in 2005
	the minimum standard in The EU Directive. This leaves the choice between the Open and Restricted procedures to the procuring entity, provided that the required advertisement procedures have been followed.		CPTR by the Government rather than Parliament.	