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FYR of Macedonia
Public Expenditure and Institutional Review

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ACRONYMS AND ABBREVIATIONS

BOO	Build-operate-own
BRA	Bank Rehabilitation Agency
CBA	Collective Bargaining Agreements
CEEC	Central and Eastern European countries
CPI	Consumer Price Index
FDI	Foreign direct investment
FIAS	Foreign Investment Advisory Service
FRY	Federal Republic of Yugoslavia (Serbia and Montenegro)
FTA	Free Trade Agreement
FWA	Framework Agreement
GoM	Government of the FYR Macedonia
GNFS	Goods and non-factor services
HIs	Health Institutions
HIF	Health Insurance Fund
IAS	International Accounting Standards
MIPA	Macedonia Investment Promotion Agreement
MUCE	Ministry of Urban Planning, Construction and the Environment
NBRM	National Bank of the Republic of Macedonia
PEIR	Public Expenditure & Institutional Review
PA	Privatization agency
PTA	Preferential trade agreement
ROW	Rest of the world
PRO	Public Revenue Office
RER	Real exchange rate
SB	Stopanska Bank
DIF	Deposit Insurance Fund
SEC	Securities and Exchange Commission
SRP	Special Restructuring Program
SSO	State and socially owned enterprises
VAT	Value added tax
ZPP	Zaved za Platen Promet (payment bureau)

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The donor community has been highly supportive of the reform agenda presented in the report and has provided the Government with substantial technical assistance to implement the recommendations.[1] The main recommendations of this report have also formed the basis for a Bank-supported adjustment operation (PSMAC) scheduled to go to the Board in 2002.

The task manager and main author of this report is Pascale Kervyn de Lettenhove. The peer reviewers were Malcolm Holmes, Stefan Koeberle, Nick Manning and Hermann Von Gersdorff. Main contributions to the report were provided by Erika Jorgensen, Juan Carlos Ginarte, Xiaoqing Yu, Loraine Hawkins (Chapters 1-3); Gord Evans (Chapter 2); Michael Reddington, Bill Radburn, William Dorotinsky and Serif Sayin (Chapter 3); Gary Reid and Jana Orac (Chapter 4). Contributions were also provided by Slobodanka Matakova, Marius Vismantas, Evgenij Najdov, and Rajna Cemerska. Kathryn Rivera and Mismake Galatis provided excellent assistance in the final document preparation.

[1] The donors include: the Dutch Government, DFID, USAID, CIDA, SIDA and the Japanese Government.

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EXECUTIVE SUMMARY

FISCAL STABILITY WITHOUT REFORM

1. The FYR Macedonia Public Expenditure and Institutional Review (PEIR) was undertaken and completed against a background of substantial political and economic disruption. In 1999, the Kosovo crisis threatened to undermine the country's accomplishments dating from 1995 in building macroeconomic and fiscal stability. This challenge was met successfully and FYR Macedonia began to make significant strides down the desired path to a modern, market-oriented, European state.[2] Unfortunately, the March 2001 security crisis intervened, as once again the country's political and economic integrity was tested. This latest conflict culminated with the ratification of the Peace Agreement by FYR Macedonia's Parliament in November 2001. Although the agreement will ultimately entail profound changes, these are not addressed in this report as it is premature to assess how the agreement will be implemented.

2. FYR Macedonia has faced daunting challenges over the last decade. Faced with a precipitate drop in GDP over the 1991-94 period, successive governments mounted impressive efforts to establish and maintain general macroeconomic stability. Inflation, which averaged 400 percent from 1991-95, was held to a 2.2 percent average from 1996-2000. The fiscal deficit, which averaged 5.5 percent from 1991-95, decreased to just 0.2 percent from 1996-2000. The strong discipline evidenced in fiscal policy contributed to a turnaround in GDP growth, where an average of -3.1 percent per annum during 1991-95 transformed to +2.9 percent during 1996-2000. Leading up to the recent security crisis, a remarkably sustained and successful fiscal stabilization effort had been achieved.

3. The 1999 Kosovo crisis exerted enormous pressure on the budget, presenting the most serious challenge to fiscal and macroeconomic stability since 1994. By end-1999, despite the relatively quick return of refugees to Kosovo, general government expenditure had increased by about 8 percent compared to 1998. However, with a relatively quick end to the crisis and higher than anticipated revenues, the deficit actually declined after being initially projected to reach as high as 5 percent of GDP. Thus, the fiscal adjustment so painfully achieved over the previous five years remained essentially in place. This stands as a significant accomplishment.

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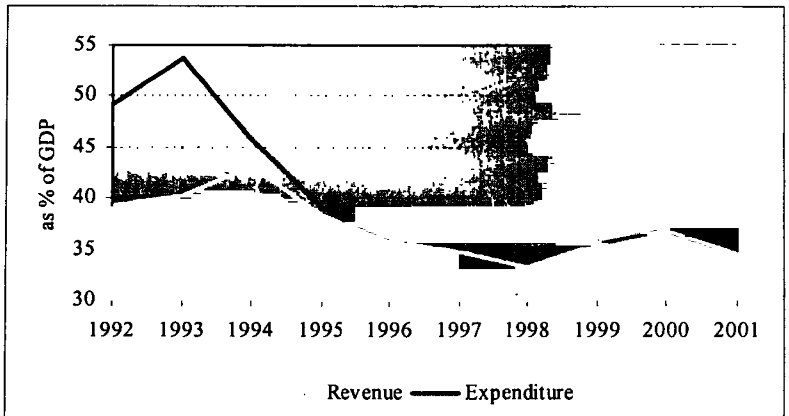
[2] FYR Macedonia and the European Union approved a Stabilization Association Agreement in 2000.

Figure 1: Public Revenues and Expenditures, 1992-2001



4. With the outbreak of the security crisis in 2001, GDP for 2001 contracted by an estimated 4.6%. Expenditure pressures arising from military and security operations have led to extensive additional spending (10 percent over budget) while revenues have declined owing to economic weakness and decreased tax enforcement. Revenue for 2001 is projected at 34.5% GDP against a target of 37% (see Figure 1). The estimated deficit for 2001 is now 6.8 percent of GDP, compared with a target of 1.2%. Clearly, fiscal stability is once again threatened.

Table 1: Economic composition of revenue and expenditure, 1993-2001 (1)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total Revenues and Grants	36.3	43.1	37.9	35.7	34.8	33.3	35.4	36.8	34.6
Total Expenditure	47.7	45.8	39	37.1	35.1	35	35.4	34.3	40.7
Current Expenditure	47.6	42.6	36.1	34.6	33.7	33.3	33.2	30.8	36.2
Goods and services	15.1	13.5	12.9	11.9	11.4	11.7	11.7	10.2	16.2
o/w wages and salaries	11.6	9.7	8.8	8.8	8.4	8.5	8.8	7.2	7.3
Transfers	..	17.8	15.6	14.6	14.1	13.5	12.7	12.8	12.3
o/w Subsidies	4.7	2.1	0.8	0.7	0.3	0.1	0.1	0.2	0.1
Social programs	..	3.2	3.7	3.3	3.4	3	3	3.1	2.4
o/w unemployment benefits	..	0.4	0.9	1.2	1.1	1.1	0.8	0.8	0.8
Pensions	..	10.9	9.4	9.2	9.1	9.2	8.6	8.2	8.6
Health	..	5.3	5.2	5.7	5.4	5.5	5.5	5.1	5.0
Interest	4.7	3.5	1.6	2	2.2	1.9	1.5	1.8	1.9
Capital Expenditure	0.8	3.2	2.8	2.3	1.4	1.8	2.3	2.7	3.4
Balance	-11.4	-2.7	-1	-1.4	-0.4	-1.7	0	2.5	-6.1

(1) General government, excluding special revenue accounts.

Source: IMF.

5. Moreover, even before the recent crisis, the achievement of fiscal stability has resulted in some significant costs. When stabilization was undertaken in 1994, government expenditures

bore the brunt of fiscal adjustment. From 1994-97, reductions in subsidies, capital expenditures, and pension payments accounted for over half of the total expenditure cuts. Lower interest payments after the restructuring of external debt in 1995 and 1996 also contributed significantly. The quality of expenditures had become an important issue by the late nineties. Although acceptable aggregate targets were being achieved, the budget's economic composition remains ill-suited for promoting economic growth and fiscal pressures have accumulated.

Imbalanced Budget

- Pension payments represented the largest component of non-discretionary spending, at over 8 percent in 1999 and 2000 and at an estimated 8.6 percent in 2001, a level of expenditure similar to Hungary and Croatia, countries whose GDP per capita is 3.5 times higher;
- While employment in the public service is comparable to other countries in the region (as a percentage of the population), it is nonetheless higher than the FYR Macedonian budget can afford. At 8.8 percent of GDP in 1999 and 7.2 percent in 2000 and 2001, the public wage bill remains under pressure from security-related hiring during the crisis and peace agreement commitments for new hires;
- Capital expenditures have been very low since the early 1990s and, in general, insufficient to replace a gradually deteriorating capital stock;

Fiscal Pressures

- Unbudgeted political commitments have now been brought into the budget;[3]
- The expenditure increases and revenue declines arising from the 2001 security crisis have created future pressures; and
- Costs of implementing the Framework Agreement (FWA) have yet to be determined.[4]

6. The challenges described above are admittedly formidable. Nonetheless, the Government has exhibited considerable tenacity in pursuing remedial reforms, even during periods of political instability. Since 1999, legal frameworks have been approved by Parliament for modern budget management, policy coordination, civil service reform, external audit, and financial control both at the center of government and in the health and social protection sectors. In several instances, the administrative infrastructure to implement these reforms has also been set in place. In looking forward, a rebalancing of expenditures will need to be implemented that offsets the funding required for structural reforms and economic growth with elimination of non-core government functions, streamlined, targeted social programs, and improved financial management throughout the public administration.

[3] These include arrears of large, loss-making enterprises on their tax obligations and debts to banks and public enterprises (especially the electric utility), which arose during restructuring of the enterprise sector; compensation for foreign currency deposits frozen at independence; and the ongoing restructuring and re-capitalization of the financial sector and, in particular, the cost to the budget of privatizing Stopanska Banka.

[4] These include increased representation of ethnic Albanians in the administration, strengthening of security forces, and decentralization of several key central functions to the local level. Main functions to be decentralized are social services, infrastructure, and other services. While the law on Local Self-Governments was approved by Parliament on January 24, 2002, an implementation plan for the law has not yet been prepared. The draft law on inter-governmental fiscal relations is yet to be finalized. A preliminary costing has been completed for implementing the FWA. The majority of related fiscal impacts are expected to occur over the medium term.

7. The 2001 peace agreement has unquestionably altered the political landscape. Nonetheless, in many ways, the medium-term institutional reform strategy approved by the Government in 2000 remains even more salient as the capacity for policy analysis, fiscal assessment of policy options, and undertaking trade-offs become essential if the policy challenges of implementing the peace agreement are to be effectively met.

INSTITUTIONAL CHALLENGES

- The core institutional question is: What changes in the structure, processes, and capacity of government would better enable it to implement the sectoral policy reforms required to expedite FYR Macedonia's transition to a market-oriented economy within the European Union? Without far-reaching institutional reform, the foundation on which this restructuring of the role of the state is to be built will remain incomplete and dysfunctional. There is a range of observable weaknesses in the present arrangements:
- Capacity at the center, although improving, remains weak. The central agencies that play a key role in coordinating policies and proposals lack strategic focus and coordination. Severe under-staffing in critical central agencies, such as the Ministry of Finance, has only recently begun to be addressed.
- Policy volatility undermines the credibility of the government and hampers growth. Because various governments have largely responded to short-term pressures, policy making lacks both consistency and continuity, which, coupled with low confidence in public institutions, serves as a deterrent to investment and ultimately economic growth. A survey of the business community confirmed the applicability of this point to FYR Macedonia. Furthermore, financing of current programs and policies weighs heavily on the country's competitiveness and contributes to the informal economy.
- No strong policy framework is guiding government's choices. While successive governments have made efforts in formulating overall development strategies (e.g. the First 100 days program; the 2001 priority-setting exercise), these have been technically limited with little capacity to monitor and evaluate results or programs.
- At the sector level, policy formulation remains weak (e.g. social protection and health). Higher poverty levels and persistent high unemployment have increased the need for social protection in FYR Macedonia. However, the social programs remain costly and inefficient, relying on excessive taxes that distort labor markets, and often prove ineffective in reaching the most needy. The Government has taken initial steps to reform all three major social protection programs, particularly by introducing a new pension framework law. However, both unemployment and social assistance require further tightening and improved targeting. The off-budget Health Insurance Fund (HIF) experienced rapid expenditure growth, large deficits and accumulated debt until 1999. Sharp improvement in the HIF's financial position was achieved in 1999 without accompanying structural change to tackle longstanding problems of inefficiency, ineffective care, and variable access to services, especially for the poor. There is the consequent risk that financial pressures have been shifted to predominantly

public sector providers and patients in an unsustainable way. Passage of a new *Health Insurance Law* in April 2000 provides the framework for introduction of some necessary reforms.

- **Budget preparation and execution processes are disjointed and provide a weak link between policy commitments and available resources**, the budget has limited credibility as a guide to government policy intentions. Although a new *Law on Budget* was approved in 2000 and several process improvements made in 2001, these were derailed by the uncertainty created by the security crisis. There is little reason for key players to regard the budget as the last word in government policy as resource allocations continue to be decided at the very end of the preparation process. Investment and recurrent budgets bear little relation with one another. Ministry budget requests are prepared without effective ceilings. Poor predictability of aggregate resources further erodes budget credibility. These deficiencies, if not addressed, will create serious problems with respect to the implementation of the peace agreement, where clear links between policy choices and fiscal consequences will be essential. The promising start made on budget reform in 2000 must be reinvigorated.
- **Government has inadequate information on which to base its proposals and defend its decisions**. To make and defend policy decisions, the Government should be informed by the costs of policies, particularly those affecting outer years. There has traditionally been little information on the fiscal costs of the extremely high volume of legislative proposals reviewed by the Government (e.g., the likely costs of the decision by the Government to grant early retirement to about 4,000 employees in 2000 were not adequately estimated and analysed). Recent moves to require mandatory costing of policy proposals will, it is hoped, address this problem. However, even with better costing of policy options, tradeoffs would be difficult, as some 45-50% of resources remain outside of the budget's purview. Three off-budget funds accounting for about 30% of resources enjoy considerable management independence. Furthermore, only about a third of donor funding appears in the budget without any link to sectors and/or projects. In addition, the limited scope and time horizon of the budget restricts the Government's ability to make choices between priority allocations.
- **The budget execution process inadequately supports the credibility of the budget as an instrument for delivering policies**. Commitment control is inadequate. Reported arrears averaged 0.5 percent of GDP in 2001 and unreported arrears may persist as reporting remains unreliable. This situation prevails largely in the health system where no reliable financial information is available and arrears to suppliers were evidenced in 2000 and 2001 (estimated at 1 billion denars as of October 2001). Stronger wage bill management also needs to be instituted. As the treasury system becomes fully functional, and process improvements are implemented in the health sector, progress in this area may be registered.
- **There are minimal transparency and accountability mechanisms in resource management inside or outside the Executive**. Much stronger internal and external accountability mechanisms need to be implemented. Internally, the absence of clear performance objectives at all organizational levels, the early

stage of development of internal audit, and the lack of a personnel performance appraisal system indicate the scope of the challenge to create a results-oriented organizational culture. Despite its strong level of influence on the Executive branch, the role of Parliament in holding the Government to account is undermined by the poor quality of information that it receives. Although the State Audit Office is operational, staffing levels remain insufficient to deliver its mandate. Finally, public accountability and the potential role of civil society in the public policy process are in their infancy. Recent measures to strengthen external audit and introduce internal audit, as well as improve the quality of information provided in the budget and policy review processes, create the basis for more robust financial monitoring and control.

- **Incentives for performance in departments and line agencies are weak.** Cuts in the wage bill have produced a compressed pay structure. They have also given ministries strong incentives to seek additional resources for personnel-related expenditures outside the budget and possibly within the budget, although the implementation of the treasury has created a more reliable link between personnel and salary information. The level of politicization remains high, although the creation of an arms-length Civil Service Agency and the development of secondary legislation to implement the *Law on Civil Servants* are positive moves towards the creation of a professional public service. Nonetheless, it still remains to be seen whether fair oversight, grievance and appeals mechanisms can be implemented. Although some service standards exist, these are rare and neither performance evaluation nor a performance measurement system are in place. Such performance gaps, combined with a high level of politicization, produce chronic organizational instability and persistent personal insecurity among employees.

8. The conjunction of these weaknesses contributes to low government performance, with the delivery of services and policy performance in FYR Macedonia remaining well below its potential. This performance gap underscores the need to improve efficiency and effectiveness of public resource management, including the need to strengthen policy formulation, budget management, and accountability.

A SEQUENCED AGENDA FOR INSTITUTIONAL REFORM

9. With the resolution of the 2001 security crisis, the need to accelerate institutional reform becomes compelling as lack of progress will adversely affect the achievement of the economic and social objectives that are fundamental to sustaining FYR Macedonia's development goals.

10. The priorities for an institutional reform agenda are to develop structures and systems that strengthen the position of the Government in presenting contentious but well-argued proposals to Parliament. This entails increasing capacity at the center of government and radically improving the quality of information on which Government bases its proposals and defends its decisions. Government must also have better information on which to review its existing programs and the budget must regain credibility as a guide to government policy intentions. Increasing transparency in and accountability for resource management is key, as is improving the incentives for performance in departments and line agencies. All of these

measures will be critical to ensuring that implementation of the peace agreement is well-planned and reliably executed. Efforts begun in 2001 to implement such an approach, both in the central government and the Health Insurance Fund, must now be revived for 2002. Without these improvements, there is a significant risk that recent threats to fiscal stabilization will erase past gains. Facing resource constraints, the quality and efficiency of public services could erode significantly. Unpredictable policies will continue to elicit low confidence in public institutions and deter investment.

11. The obstacles to achieving these priorities are substantial. FYR Macedonia's limited resources, both human and financial, pose a fundamental constraint. FYR Macedonia is not in a position, for instance, to upgrade significantly the capacity of its entire public administration within, say, two to three years. The Government will need to focus its efforts on elements of the public administration that are critical to the reforms and sufficiently circumscribed that concerted attention will multiply the impact.

12. Ideally, the reform program would be permitted to unfold in a logical, sequenced manner. First, efforts would focus on reallocating resources towards priority areas within the imposed fiscal constraints. Second, the necessary accountability, transparency, and incentives to sustain the initial institutional reforms would be entrenched. However, the urgency and scope of demands arising from the peace agreement will necessitate, in many instances, parallel rather than sequential implementation. Although a solid base to the reforms has been built, it would be unrealistic to downplay the scope of the challenge ahead.

Phase 1: Improve allocation of resources within fiscal constraints.

13. **Reduce demands on public resources.**

- *Eliminate non-essential programs, policies and services.* Some initial divestment of non-core activities and the development of a short-term plan for further actions have been completed. The next steps will need to identify a much broader and more significant set of non-essential programs and services; i.e., programs and services that could eliminated altogether or more appropriately and efficiently be provided through the private sector. Activities formerly funded through special revenues offer one promising area of investigation. A major effort must be undertaken to eliminate duplication (through program or functional reviews) and find more efficient ways to deliver existing services. Complementary to this, short-term rationalization of expenditures in the health and education sectors needs to be undertaken.
- *Reduce waste in the use of resources*: Improvements in expenditure control and monitoring are required: (i) the new treasury system's capability to ensure commitment control and monitor and control employment and the wage bill have to be fully developed. (ii) agreed ceilings in place on guarantees need to be enforced; (iii) in the health sector, the new by-laws in financial management and the global-budget contract for hospitals need to be implemented; systematic controls for procurement strengthened; targeted eligibility in selective areas assured; surplus doctors and dentists reduced in primary health care; (iv) in the

social protection sector, the pension supervision agency needs to be established; and program administration and benefit delivery improved.

14. **Strengthen resource prioritization, notably through capacity building, better information, and process improvements.**

- *Enlarge the information basis available to decision makers for the budget.* Improved information on off-budget funds and donor funding by sector and projects needs to be provided. The costs and options for public enterprise, banking, and pension sector reforms should be planned and identified. Also essential in the medium-term are cost estimates for implementing the Framework Agreement.
- *Increase budget shares in priority functional areas and economic classifications:* Within a sustainable fiscal plan, and with identified offsets, adequate provision should be made for priority reforms and functions of the Government. Quality investment spending that contributes to economic growth should be increased.
- *Increase predictability of funding.* The macroeconomic and revenue forecasts used in the budget should be based on conservative estimates to avoid shortfalls that undermine the budget's credibility and the delivery of priority commitments. With the new treasury operational, the Ministry of Finance should provide at least quarterly reports to the Government on budget execution by ministry with rationales for any deviations from planned allocations.
- *Improve the budget process.* With the new *Law on Budget* and the Government's approval of process improvements for the 2002 process, it was intended that the budget process would be priority-driven, produce a fiscal strategy based on a sound macroeconomic framework, and begin in the Spring. However, with the onset of the security crisis, a macroeconomic framework was never finalized, revenue estimates did not properly anticipate the negative economic impacts, and sector ceilings were never established. This process needs to be revisited and strengthened for the 2003 budget process. Budget reforms are taking place both in the central government and the Health Insurance Fund.
- *Mandatory costing of new policies and programs:* The Government approved this requirement in 2001, where the short and medium-term fiscal implications of all policy proposals had to be identified prior to Government review. This new approach requires considerable strengthening and is needed to ensure that the financial impacts of implementing the peace agreement are properly taken into account.

15. **Lay the legal framework for furthering administrative and budget management reforms.**

- Although the number of ministries has been reduced, the Law on Organization and Work of the Administrative Bodies continues to present barriers to divesting non-core activities. Some alternative legal mechanism that does not require a two-thirds vote in Parliament to approve virtually any restructuring initiative needs to be found.

- The development of secondary legislation to implement the *Law on Civil Servants* is underway and needs to be completed. The Agency for Civil Servants needs to be able to ensure depoliticization occurs.
- The salary decompression mandated by the salary structure established in the *Law on Civil Servants* needs to be implemented, but must be based on careful financial simulations to ensure that the fiscal impact of converting to the new position scheme and salary structure set out in the *Law on Civil Servants* is fiscally sustainable.

Phase 2: Institutionalize the reforms through stronger accountability and capacity building.

16. **Strengthen policy prioritization systems and capacities.**

- Institute a multi-year budget process where medium and longer-term policy reforms are carefully planned within a multi-year fiscal strategy that ensures policy trade-offs.

- Implement management and organizational changes in the Ministry of Finance and the General Secretariat that will enable these organizations to play a leadership role in implementing this system.
- Utilize the new treasury system as a planning tool to ensure that past financial performance informs future policy decisions for both budget and off-budget activities.

17. **Strengthen accountability systems and capacities.**

- Strengthen the external (State Audit Office) and internal audit functions.
- Ensure the Public Revenue Office effectively assumes all responsibilities devolved to it from ZPP.
- Establish and launch an action plan for strengthening human resources management capacities and developing a professional, meritocratic, performance-oriented civil service.
- Restructure and strengthen central human resource management capacities, focusing on the new Agency for Civil Servants. This will be essential in meeting both the letter and the spirit of the peace agreement's objectives for increasing minority hires.

18. **Advance policy reforms in health and social protection.**

- *Unemployment.* Further amendments will be needed to the *Law on Employment* and the *Law on Labor Relations*, based on a labor market analysis, to ensure that strong incentives exist for the unemployed to seek work in the formal sector; as well as to improve benefit coordination across social protection programs.
- *Pensions.* Approval of a draft *Law on Private Pension Funds* will be required. The Pension Supervision Agency should become operational, as a prerequisite for the second pillar of the pension system to be introduced. Further develop

financial markets and create a public debt market (e.g., establish Treasury securities and attract limited international investment).

- *Social Assistanc.* Tighten eligibility and improve poverty targeting; develop programs that encourage community participation to assist the poor.
- *Health.* Rationalization of the hospital network and organizational reform of primary health care need to proceed, including planned privatizations. Contribution rates and revenue sources need to be reviewed to balance ability to pay against expected use of services.

19. **Foster public participation in policy formulation and service quality improvement at the operational level through the following actions:**

- Establish accountability benchmarks against which public agencies and programs can be judged.
- Ensure that the budget process requires evidence of accountability (e.g., audited accounts with clean bill of health, evidence of how well and how cost-effectively policy/program objectives are being achieved).
- Provide evidence on the extent to which priority-setting and the budget process have become more focused on policy objectives (repeat officials survey; initiate other surveys to gather similar evidence from other target groups; also launch service delivery surveys and other means of soliciting systematic feedback from citizens).
- Implement action plan for strengthening human resource management capacities and achieve initial benchmarks for a professional, meritocratic, performance-oriented civil service (e.g., successful introduction of performance evaluations).
- Strengthen public accountability through improved access to information, public budget plans and results reporting, and more active involvement of civil society in public policy deliberations.

CONCLUSIONS

20. This report offers a strategy that focuses initially and unambiguously on actions at the center of government. This is premised on the contention that a well-functioning, transparent, forward-planning center is essential to the ultimate success of pressing but complex policy reforms and anti-poverty strategies. Effective delivery of essential services and appropriate economic regulation remain the overarching objectives of government, but these must be enabled through a set of institutional reforms and improved planning and accountability mechanisms. Otherwise, the development of a stable and attractive regulatory regime by the Government of FYR Macedonia will remain elusive.

21. **The need to continue these institutional reforms and regain the momentum that was in place prior to the security crisis is urgent, both with respect to implementing effectively the Framework Agreement and addressing the resulting fiscal pressures. In the longer term, FYR Macedonia's ambitions to join the EU can only be fulfilled if institutional capacity is dramatically increased.**

REPORT ORGANIZATION

22. The report is organized into four chapters dealing successively with different aspects of public policy and resource management. Chapter 1 focuses on the issue of fiscal stability, assessing the record of and prospects for FYR Macedonia to live within its means. Generally, a laudable and successful effort since 1995 has been undertaken by successive governments to achieve macroeconomic and fiscal stabilization, although the 2001 security crisis has reintroduced challenging fiscal pressures. Stability has been achieved at a cost, as the Government has tended to resort to ad hoc measures without any strategic basis. The analysis concludes that the commitment and dedication exhibited by the Government in achieving macroeconomic and fiscal stability must now be directed at those problems affecting the quality of public expenditures. On a cautiously positive note, the Government has, for the most part, taken important initial steps towards institutional reform. The chapter concludes with a broad fiscal scenario, looking to the medium-term, indicating how a sustainable path can be achieved if the Government perseveres with a medium-term institutional reform strategy.

23. Chapter 2 then explores the institutional challenges facing effective policy formulation, where informed policy trade-offs are made within a sound fiscal plan. The analysis credits FYR Macedonia's peacetime political structure as being conducive to promoting effective policy making, but stresses that critical institutional and capacity weaknesses undermine this objective. Most problematic in this regard are the institutional arrangements at the center of government where the policy process is poorly supported and disconnected from the budget process. Significant gaps in transparency and accountability exacerbate these problems. Although the recent crisis has magnified these shortcomings, the Government has put in place the base for future progress in tackling the capacity and process issues that hamper effective policy formulation.

24. Chapter 3 turns to an analysis of budget implementation where the tenuous link between policies and resources in FYR Macedonia becomes most evident. Failures at this stage of the resource allocation process reflect and magnify policy formulation weaknesses, leading ultimately to socio-economic outcomes well below FYR Macedonia's potential. The analysis focuses on financial management practices that have undermined the credibility of the budget. While acknowledging that a significant turnaround in this area is now underway, problems continue to exist in both the central government and the extra-budgetary funds, most notably the Health Insurance Fund. Monitoring and control mechanisms remain limited and gaps in accountability permeate all critical Government processes. The Government is now taking measures to address these deficiencies by strengthening external audit, introducing internal audit, and improving the quality and timeliness of information available to decision makers, central agencies, and, ultimately, to Parliament and the public.

25. Chapter 4 addresses problems in human resource management, where fair, transparent, and performance-oriented civil service management practices were largely absent. Problems analyzed in detail include counterproductive pay and employment levels, the inability to set meaningful performance objectives at all organizational levels, and the high level of politicization that continues to undermine productivity and continuity within the civil service. Now that Parliament has approved an appropriate legislative framework, with an arms-length agency established to oversee its implementation, the Government may begin to turn the corner

on chronic underperformance owing to a politicized, unmotivated civil service. This vacuum has in the past resulted in arbitrary practices and inadequate incentives to improve performance at all levels of government.

1. FISCAL STABILITY WITHOUT REFORM

INTRODUCTION

1.1 The starting point for this chapter is FYR Macedonia's successful record in restoring fiscal stability following severe economic and fiscal problems in the early 1990s. From 1994 forward (see Table 1.1), the Government has managed, for the most part, to retain fiscal discipline despite the turmoil caused by the 1999 Kosovo crisis and the 2001 security crisis. This chapter elaborates how fiscal stability has not been achieved without costs. In many instances, fiscal problems and needed policy reforms have simply been deferred. Problems to be highlighted include imbalanced expenditure reductions, accumulation of unbudgeted liabilities, unsustainable pay and employment structures, and the slow pace of fiscal reform in the health and social protection sectors. The chapter concludes with a scenario that blends institutional and structural reforms within a stable fiscal environment. Later chapters will describe measures that the Government is taking to address these problems, as well as propose an institutional reform strategy to create the foundation for enduring policy reform. In presenting this analysis, it is important to acknowledge the advances towards this goal achieved by the Government since 1999 against an extremely challenging political environment.

FISCAL ADJUSTMENT SINCE 1994: REGAINING FISCAL STABILITY

1.2 Economic volatility, soaring inflation and deteriorating fiscal and external balances quickly followed independence in 1991 (see Table 1.1). By 1995, GDP had contracted 20 percent, with registered unemployment contracting by well over 30 percent. A shrinking economic base eroded tax revenues while social spending ballooned. Pension expenditures, for example, reached an unsustainable 11 percent of GDP by 1994[5]. The 1993 general government fiscal deficit exceeded 11 percent of GDP. In the absence of financing sources, shortfalls were addressed by running arrears on domestic and foreign debt.

1.3 **Fiscal stabilization, initiated in 1994, was achieved largely through expenditure cuts.** While expenditures fell from 53.6 percent (1993) to 39.0 percent of GDP (1995), revenues actually rose in 1994, due to tax reforms, before falling to 38.3 percent of GDP in 1995 from 40.2 percent in 1993. Thereafter, revenues fell (both in real terms and as a share of GDP) towards a more appropriate long-term level of about one-third of GDP until the recent increase owing to the April 2000 introduction of VAT. At the end of 2000, revenues were 3.4 percent of GDP below their 1993 level, while expenditures had plummeted by 19.3 percent of GDP to just over one-third from more than half of the national income (see Chart 1.1). An upsurge in expenditures in 2001, accompanying the security crisis, has reversed this trend.

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[5] These high costs can be attributed to generous entitlements and the high number of workers opting for early retirement.

Table 1.1: Key Macroeconomic Indicators, 1991-2000

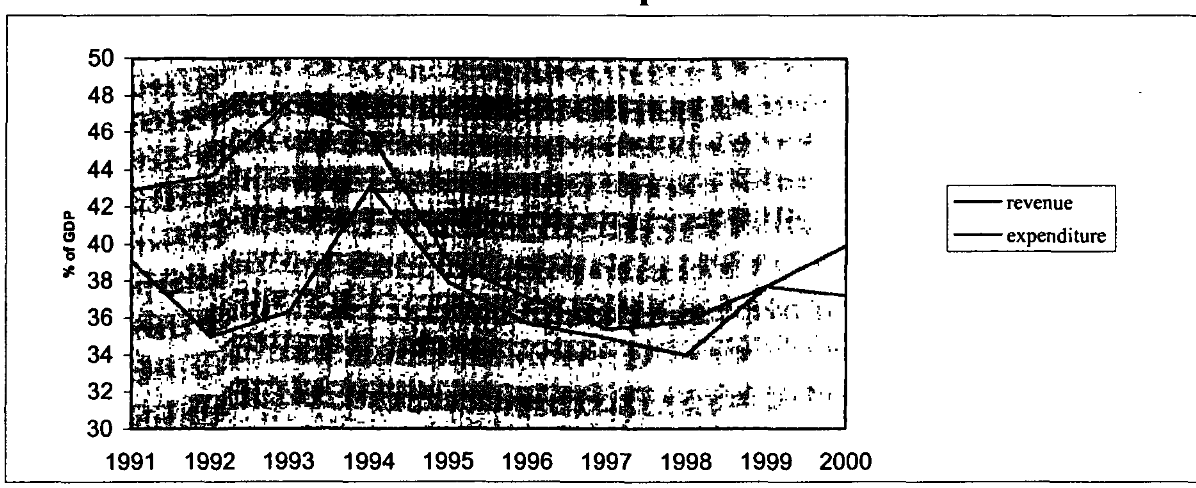
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
				(% change)						
Gross domestic product	-6.6	-7.5	-1.8	-1.1	1.2	1.4	3.4	4.3	4.3	-4.6
Inflation (1)	1323	401	127	17	3	3	0	-0.7	5.8	5.5
				(in % of GDP)						
Current account balance	..	0.6	-4.7	-5	-6.5	-7.4	-8.6	-3.7	-3.3	-10.8
Fiscal deficit (2)	-9.8	-13.4	-2.7	-0.7	-1.4	-0.4	-1.7	0	2.5	-6.1
Revenue (3)	39.3	40.2	43.1	38.3	35.7	34.8	33.3	35.4	36.8	34.6
Expenditure	49.1	53.6	45.8	39	37.1	35.1	35	35.4	34.3	40.7

Notes: (1) Inflation is average annual change in retail prices; (2) Fiscal deficit is of general government; (3) Revenue includes grants.

Source: IMF; National Statistical Office; National Bank of Macedonia.

1.4 The 1999 Kosovo crisis initially placed enormous pressures on the budget and presented the most serious challenge to fiscal and macroeconomic stability since 1994. The hostilities severed FYR Macedonia's predominant trade route as refugees flooded into the country's northern region. However, with the relatively quick return of refugees to Kosovo, general government expenditures rose only marginally higher than in 1998 and were more than offset by strengthened tax collection. The deficit, at one point projected to reach as high as 5 percent of GDP, actually declined. Thus, **despite the fiscal pressures created by the Kosovo crisis, the fiscal adjustment so painfully achieved over the previous five years remained in place**.

Chart 1.1 Revenue and Expenditure: 1991-2000



Source: IMF; National Statistical Office; National Bank of Macedonia.

1.5 FYR Macedonia's success in sustaining fiscal discipline from 1994-2000 is laudable. Nonetheless, several challenges persist. The discretionary component of expenditure has declined from 19 percent in 1994 to roughly 15 percent of total spending in 2000.[6] Wage bill targets have constantly proved difficult to achieve. Tax rates, especially on labor, remain high, discouraging new investment and expansion of formal employment.

Table1.2: Economic Composition of Revenue and Expenditure, 1993-2000

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total Revenues and Grants	36.3	43.1	37.9	35.7	34.8	33.3	35.4	36.8	34.6
Total Expenditure	47.7	45.8	39	37.1	35.1	35	35.4	34.3	40.7
Current Expenditure	47.6	42.6	36.1	34.6	33.7	33.3	33.2	30.8	36.2
Goods and services	15.1	13.5	12.9	11.9	11.4	11.7	11.7	10.2	16.2
o/w wages and salaries	11.6	9.7	8.8	8.8	8.4	8.5	8.8	7.2	7.3
Transfers	..	17.8	15.6	14.6	14.1	13.5	12.7	12.8	12.3
o/w Subsidies	4.7	2.1	0.8	0.7	0.3	0.1	0.1	0.2	0.1
Social programs	..	3.2	3.7	3.3	3.4	3.0	3.0	3.1	2.4
o/w unemployment benefits	..	0.4	0.9	1.2	1.1	1.1	0.8	0.8	0.8
Pensions	..	10.9	9.4	9.2	9.1	9.2	8.6	8.2	8.6
Health	..	5.3	5.2	5.7	5.4	5.5	5.5	5.1	5.0
Interest	4.7	3.5	1.6	2	2.2	1.9	1.5	1.8	1.9
Capital Expenditure	0.8	3.2	2.8	2.3	1.4	1.8	2.3	2.7	3.4
Balance	-11.4	-2.7	-1	-1.4	-0.4	-1.7	0	2.5	-6.1

(1) General government, excluding special revenue accounts.

Source: IMF.

1.6 **The 2001 security crisis and the implementation of the subsequent Framework Agreement create new fiscal pressures.** 2001 GDP is projected to have declined 4.6 percent compared to an original estimate of 6 percent growth. The deficit will reach 6.8 percent. Planned tax reductions were shelved; instead, a new tax on financial transactions, expected to raise 1 percent of GDP in revenues, was imposed effective July 1, 2001. As a result, overall, revenue will have increased to 34.5 percent of GDP (still a decline of 2.3 percent from 2000) while expenditures will have soared to 41.3 percent of GDP (an increase of 6.8 percent from 2000).

BUDGET IMBALANCE AND GROWING FISCAL PRESSURES

Revenues

1.7 Three issues arise from FYR Macedonia's revenue structure. First, although total fiscal revenues are comparable with those of other transition economies with similar levels of income[7], social contributions are high. By international standards, the structure of revenues is highly concentrated on tax revenue (see Table 1.3). In FYR Macedonia, labor taxes constitute approximately 80 percent of tax revenue, creating relatively high unit labor costs and discouraging investment and job creation in the formal sector. Although the payroll tax rate for

[6] World Bank estimate

[7] The introduction of VAT in Macedonia in April 2000 has not significantly increased the share of tax revenue in total tax revenue

state pensions is modest, the cumulative payroll tax exceeds 30 percent of the gross wage. All labor taxes together (including income taxes) increase gross labor costs by 60-80 percent in an economy where net wages are high relative to many of FYR Macedonia's competitors (mostly in emerging economies outside of the region).

Table 1.3: Central Government Revenues and Expenditures in Central Europe, 1999 (as % of GDP)

	FYRM (1)	Bulgaria	Hungary	Poland	Slovakia
Total Revenue and Grants	35.4	36.1	38.8	32.7	37.0
Current Revenue	35.2	34.6	38.5	32.4	36.8
Tax revenue	33.9	26.8	33.9	29.0	30.7
Non-tax revenue	1.3	7.9	4.6	3.5	6.0
Total Expenditure	35.4	35.7	42.6	35.3	37.2
Current Expenditure	33.2	31.8	39.0	33.9	33.9
Goods and services	11.7	11.9	6.9	5.5	8.7
wages and salaries	8.8	2.8	3.6	2.7	4.9
other goods and services	2.9	9.1	3.3	2.8	3.8
Subsidies	0.1	1.7	2.3	0.8	3.1
Other current transfers	12.6	14.3	22.4	24.5	18.9
Interest	1.5	3.9	7.4	3.1	3.1
Capital Expenditure	2.3	n.a.	3.6	1.5	3.3

Source : IMF; (1) General Government

1.8 Second, control and allocation of public revenues are complicated in FYR Macedonia by the existence of special revenues, collected by line ministries (usually as fees for service). Although they are now part of the Single Treasury Account (STA), their allocation remains at ministry discretion. In 2002, the Government intends to budget special revenues originating from fees, fines, etc. (613 accounts). This implies that allocations, as well as deposits from such special revenue accounts will be incorporated into the regular budget process. In 1999, when special revenues were still off-budget, they constituted 16 percent of central government revenue and were predominantly in the ministries of Education, Interior, and Defense. These "own resources" are a source of overall budget inflexibility, as discussed in detail in Chapter 2.

1.9 Third, collection of VAT, formerly the responsibility of ZPP, has been transferred to the Public Revenue Office (PRO). The PRO and extra-budgetary funds share the responsibility for earmarked payroll tax collection. This transfer of responsibility raises the threat of a drop in collection rates during the transition period to a voluntary system and highlights compliance issues, as evidenced by VAT collection in 2001. In fact, the PRO has now undertaken an ambitious plan to reduce arrears in VAT collection, with a medium-term goal that 90 percent of VAT arrears will be discharged within six months. The plan focuses on the highest abusers; i.e., 138 taxpayers who accounted for roughly 61 percent of the total arrears.

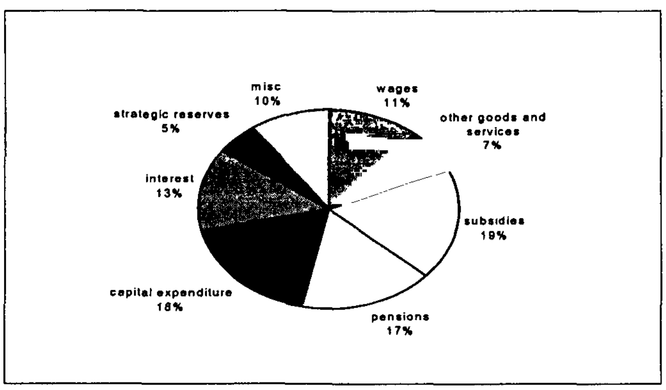
Expenditures

Imbalanced Expenditure Reductions

1.10 From 1994 to 1997, severe expenditure cuts were focused on social transfers and capital expenditures. Lower interest payments after the restructuring of external debt in 1995 and 1996 also contributed significantly (see Figure 1.1). Since 1997, reductions have continued, although these have been more equitably distributed across different economic classifications. Although these reductions have contained both desirable and undesirable impacts, overall, the quality of fiscal adjustment has been adversely affected:

- Budget subsidies to agriculture and industry were eliminated over 4 years, but enterprises instead built up arrears to the tax authorities, the state-owned electrical utility, domestic banks, and their own workers;
- The squeeze on capital expenditure from an already low level of around 3 percent of GDP in 1994 to less than 2 percent in 1997-98 undermined public provision of infrastructure and other services necessary for economic growth in the medium term. The dearth of such spending has resulted in disrepair of existing schools, highways, and other public facilities;
- The surge in pension payments was halted and modestly reversed, but the courts have ordered a significant increase in pensions for certain groups of retirees as compensation for the missed indexation that had helped reduce pension costs to the government;
- Interest payments, both domestic and foreign, have fallen by two-thirds as a share of GDP between 1993 and 2000. Debt and debt service reduction agreements with the Paris and London Clubs in 1995 and 1997 respectively, followed by conservative foreign borrowing, mostly from subsidized sources, have cut foreign interest payments, while high inflation in the early 1990s appears to have eased the real interest burden of domestic debt; and
- Although spending on public wages and salaries was reduced by almost 4 percent of GDP between 1993-2000, few measures have been adopted to decrease the size or range of functions of the public service. Instead, wages have been frozen, solidifying a compressed salary structure that compromises the attraction and retention of highly-skilled staff (see Chapter 5).

Figure 1.1: Distribution of Expenditure Cuts, 1994-97



Source : Government, Ministry of Finance

Future Expenditure Pressures

1.11 The choices outlined above illustrate how an imbalanced budget structure was one consequence of achieving fiscal stability. Another was a growing stock of arrears and the more difficult problem of complex off-budget guarantees and subsidies. Essentially, short-term fixes were chosen over comprehensive reforms in social protection, health, education, and civil service management.

1.12 Until 1999, the Government tended to run arrears to control the cash deficit, particularly in social transfers (temporarily), health sector payments, and in payments promised to the holders of foreign exchange deposits frozen at the time of the breakup of Yugoslavia. Although the Government has aggressively tackled arrears among ministries, **the reporting of arrears remains unreliable overall and the accumulation of arrears persists in the social sectors**. At the end of 1998, an estimated 3.9 billion denars was owed to suppliers by several ministries and the Health Fund. Ministries have since repaid the 400 million denars that constituted their share. The Health Fund, however, which has generated most of the past government arrears, is still not making payments on a timely basis as providers were again accumulating arrears in 2001.[8] Pension arrears have also proved problematic. The Government's 1994 decision to freeze pension payments, as a short term cost-savings measure, was overturned in 1999 by the courts, which determined that pensions should have been indexed by 8 percent. This increase is now being paid on current pensions, with the accumulated arrears, estimated unofficially at US$100 million, being repaid from the central government budget.

1.13 **The pattern since independence of a substantial buildup of off-budget and contingent liabilities places further destabilizing pressure on the budget.** In 1999, loan guarantees were estimated at USUS$44 million, mostly on foreign borrowing. However, even the total amount of loan guarantees is not known. Although a register has existed since 2000, it is unclear that it is comprehensive as different ministries (such as Defense) have extended guarantees in the past without seeking approval from or informing the Ministry of Finance. The Government has now taken steps to discontinue this practice with changes in 2000 to the *Law on Budget,* requiring individual guarantees to be adopted by Parliament (see Chapter 2).

1.14 **Significant off-budget commitments have consistently accumulated in the banking system**, with some of these transforming into explicit budget commitments. One of the most costly examples relates to foreign currency deposits confiscated prior to the breakup of the former Yugoslavia by the authorities in Belgrade. These are currently valued at DM 1.1 billion, equivalent to 17 percent of GDP. Although the Government agreed to compensate depositors shortly after independence, the sheer size of the obligation has prevented complete repayment. The ongoing budget cost of this government obligation has now been tied down with the Government decision to pay off small depositors and transform the remaining obligation into a long-term bond, at a budget cost averaging 1-2 percent of GDP per year.[9]

1.15 Beyond this one-time obligation, the restructuring and re-capitalization of the financial sector that began in 1995 has cost the budget about 2.5 percent of GDP. Moreover, new liabilities have accumulated as restructuring remains an ongoing effort, with unresolved problems in corporate governance. For example, as a condition of privatizing Stopanska Banka, the largest, state-owned bank, the agreement with foreign buyers stipulated that DM 225 million

[8] Due to accounting and reporting weaknesses, numbers on arrears are considered unreliable. It is quite possible that unreported arrears to suppliers have increased in 2001 due to fiscal pressure on the budget.

[9] The plan provides full repayment to small depositors (with accounts worth Euro 50 or less) and a payment of 3 percent of account balances to all other depositors in 2000, at a cost of 1.35 billion denars. A 10-year bond was issued at the end of 2000 for the remaining account balances, paying 1 percent interest with 2 years' grace period. This compensation plan is estimated to cost the budget from 0.6 to 1.4 percent of GDP during each of the next 6 years. In 2000, the Government paid 1.7 percent of GDP in principal and interest.

of non-performing loans to some the largest loss-making enterprises were to be removed from the Bank's books and replaced by a 15-year government bond.

1.16 In the near future, **the largest additional budget costs may arise from restructuring the enterprise sector**, which could require the government to assume responsibility for the borrowings of privatized or liquidated loss-making companies and to pay various employment-related costs. According to IMF estimates, the employment-related costs of the nine largest such enterprises could amount to the equivalent of 1.6 percent of 2000 GDP for severance payments, unemployment benefits, and the payment of enterprise arrears to the pension and health funds. The arrears of large loss making enterprises on their tax obligations and debts to banks and public enterprises (especially the electrical utility) are also significant. For the nine largest loss-making enterprises, this implicit cost to the budget will likely become explicit as the firms are sold or liquidated and the liabilities that cannot be paid off become direct government obligations. The estimated cost to the budget is about 470 million denars in arrears to domestic suppliers, or about 0.2 percent of GDP.

1.17 It is of concern that the Government has employed less transparent interventions in the financial and public enterprise sectors, negotiating out of the public eye to assume various enterprise debts and to provide longer-term subsidies to strategic investors.[10] To prevent these expensive bail-outs of state-owned enterprises and financial institutions from recurring, financial discipline must be strengthened, through improvement of the legal framework to protect creditors' rights, including improvements to the laws on bankruptcy, collateral, and prudential banking regulations. In addition, the Government needs better monitoring of such liabilities and ongoing assessment of financial imbalances in the enterprise and banking sectors.

1.18 The substitution of hard-to-measure obligations to support enterprises and financial institutions for direct subsidies in the budget reflects the lack of real progress on sustainable fiscal adjustment. The implementation of the 2001 peace agreement and ongoing security-related expenditures will add an additional burden on fiscal sustainability in the medium-term. With growing pressures and increasingly limited budget flexibility, fiscal stability will need to be maintained by implementing deeper fiscal reforms in the social sector and the wage bill through more aggressive government restructuring. These issues are revisited at the end of this chapter where a medium-term scenario is presented for a fiscally sustainable budget that will facilitate economic growth.

PUBLIC SECTOR EMPLOYMENT AND PAY STRUCTURES

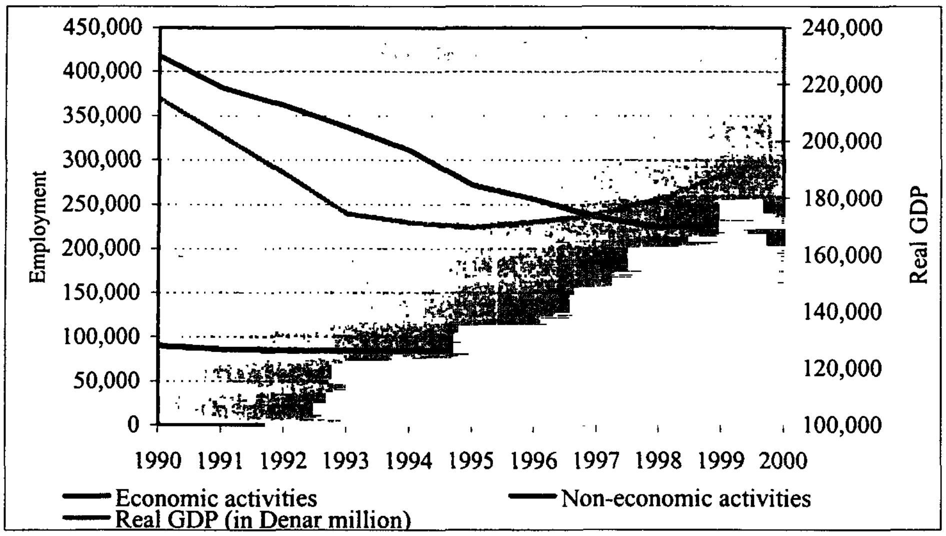
Public Sector Employment Structure

1.19 Public employment has been slow to respond to the shift from a state-dominated society to a market economy, as the changes in roles and responsibilities that one would normally expect to accompany this shift have lagged. While FYR Macedonia's economy has undergone dramatic changes since 1990, there appears to have been relatively little adjustment in public administration employment levels (see Figure 1.2). Aggregate employment in the non-economic sphere (essentially a proxy for the public sector, as this category includes administration and defense, education, health and social welfare) declined only slightly in the 1990s. By contrast,

[10] The IMF's "Fiscal Transparency Code" emphasizes that clarity of roles between the public and the private sectors is one of the main conditions for fiscal transparency. In transition economies, the blurred distinction between the two sectors is one of the main causes of limited transparency in fiscal management.

the fall in GDP over the early to mid 1990s was accompanied by steady and substantial decreases in employment levels (approaching a 50 percent decline by the end of the decade) in the economic sphere, which largely comprises the private sector.[11] Compared to non-economic activities, **the large difference in apparent responsiveness of employment in economic activities raises questions regarding the degree to which the current level and structure of government employment remains appropriate.**

Figure 1.2: Employment and GDP Trends, 1990-2000



1.20 **Overstaffing appears prevalent in the social sectors.** In health, for example, employment of both medical personnel and support staff is excessive relative to demand for services. In education, the proportion of non-teaching staff in elementary and secondary schools is larger than levels commonly found in OECD countries, and there are also indications that teaching staff are under-utilized[12]. At the same time, understaffing of organizations or organizational sub-units in areas that would be expected to lead public sector reform may, in part, explain the slow progress in this area. **Understaffing in core functions (e.g., financial management and control) is an important contributing factor to the poor capacity of FYR Macedonia's policy-making institutions** to effectively support Government and Parliament in adjusting policies to evolving economic and social realities.

1.21 At approximately 4.5 percent of population, FYR Macedonia's general government employment level (excluding state owned enterprises and armed forces) does not seem excessive relative to a sample of twelve Central and Eastern European countries[13]. FYR Macedonia falls

[11] Note that these employment statistics may be influenced by the growth of the informal economy and suspected underreporting of private sector employment. Also note that the decline in employment in the economic sphere continued even after the resumption of growth in GDP, suggesting that productivity may have increased.

[12] However, it is important to note that this overstaffing is due to many factors, including politicized hiring practices, workload norms that are lower than in west European countries, and structural inefficiencies in networks for provision of health and education services.

[13] Note, however, that international comparisons of such highly aggregated data are notoriously difficult to interpret, since they are subject to a wide variety of measurement problems as well as variations in social and economic conditions as well as in public sector structure and activities.

toward the lower end of this group, below the sample average of just over 6 percent of population.[14]

1.22 However, with the wage bill at 7.2 percent of GDP (projected) in 2001, FYR Macedonia is in the high range when compared to other Central and Eastern European countries. Moreover, with general government wage expenditures at 24.5 percent of total expenditures in 1999 and 20.9 percent in 2000, FYR Macedonia again placed near the top of a nine-country sample.[15] Comparing the strength of FYR Macedonia's economy with its neighbors further indicates that average central government wages in FYR Macedonia, as a multiple of per capita GDP, are somewhat higher than in neighboring countries. Thus, **despite fairly restrained government employment levels, FYR Macedonia's relative poverty accentuates wage bill costs relative to GDP** (see Chapter 4 for further discussion of wage and employment levels).

Pay Structure

1.23 **These aggregate affordability problems are intensified by a salary structure that impedes the public sector's capacity to attract, motivate and retain key skills.** Anecdotal evidence indicates that some segments of the government workforce, specifically, staff in senior professional and managerial positions, or with particularly attractive skills such as finance expertise, may well be underpaid relative to their private sector counterparts, whereas wages for other staff may be in line with or above the broader labor market. Similar patterns of declining competitiveness with increasing rank or skill have been observed in other developing countries.[16]. The resulting skill deficit in critical areas adversely affects the capacity of FYR Macedonia's policy-making institutions to effectively support Government and Parliament in adjusting policies to evolving economic and social realities.

1.24 Recent revisions in the legal framework governing human resource management provide an opportunity for the Government to address this salary structure impediment to more effective governance. The *Law on Civil Servants*, passed in July 2000 and amended in April 2001, mandated a uniform and less compressed salary structure for all civil servants, to take effect January 1, 2002.[17] The number of positions covered by this Law is still unknown, but estimated to be somewhere between about 8,500 and 20,000, or roughly 15% to one-third of general government employment. To offset the costs of salary decompression, the Government will have to make significant net employment reductions within overall general government employment prior to implementing that new salary structure. Otherwise, the new civil service salary structure will have to be pegged too low to significantly enhance the attractiveness of employment within the higher ranks of the civil service.

1.25 To achieve this goal, and to minimize service disruption, government will need to emphasize shedding non-core activities as part of a broad government restructuring. The initial

[14] Note that affluent countries generally have higher fractions of public employment than do poor countries, where a sample of 20 OECD countries indicates general civilian government employment of 7.7 percent of population Source: *An International Statistical Survey of Government Employment and Wages*, World Bank, 1997.

[15] Turkey, Croatia, Albania, Poland, Slovenia, Hungary, Romania and Bulgaria.

[16] See, for instance, Gary J. Reid and Graham Scott, "Public Sector Human Resource management: Experience in Latin American and the Caribbean and Strategies for Reform," Green Cover Report No. 12839, Public Sector Management Division, Technical department, Latin American and the Caribbean Region (World Bank, Washington, DC: March 14, 1994).

[17] The date of effectiveness of the new salary structure has since been postponed until January 1, 2003, in order to permit adequate time to make the employment reductions required to allow financing of the new salary structure within a fiscally sustainable wage bill envelope.

efforts on divestment started in 2000. Progress was slow in the early stages, as Government restructuring was largely confined to collapsing the number of ministries (with no significant employee reductions) and removing from the 2001 budget roughly 170 small organizations (mostly cultural and sports associations). The Government has since responded more vigorously, and focused on those activities that clearly were non-core and could be eliminated altogether or divested without developing an elaborate legislative framework.[18] The divestment program is reflected in the 2002 budget and moves the work currently performed by nearly 900 public employees into the private sector or imposes a fee for service arrangement. Furthermore, work is underway that could lead, in 2002, to the further divestment of functions for more than 500 employees. The Ministry of Finance has also planned a second wave of divestments for 2002-2003 that would be additional to these totals. By February 2002, concrete actions have included: approval by Government of legislation to divest the Court Expertise Service to the private sector (30 positions); funding withdrawn for 2002 for several non-core educational institutions (391 positions),[19] and approval of a wide-ranging divestment to the private sector of services from the General and Common Services Bureau[20] (448 positions).

1.26 If an aggressive divestment program is to proceed over the medium term, the Government will need to consider a centrally-driven functional review task force, drawing on external expertise (local and international) and involving public consultation and civil society participation. Close coordination with the budget process and policy reform priorities would need to be observed; for example, the policy and financial management reforms identified in this report for the social protection and health sectors.

FISCAL REFORMS IN KEY SECTORS: HEALTH AND SOCIAL PROTECTION

Health Sector: Institutional Issues

1.27 **The health insurance system in FYR Macedonia has experienced ongoing financial imbalances, exacerbated in recent years by high expenditure growth.** Since independence, the health system has struggled to deal with a 40 percent real decline in public revenues for health, resorting to cuts in wages and capital expenditure, allowing shortages of pharmaceuticals and other consumables in the public health system, and delaying payment on supplier credits. Health expenditure growth has been rising, reaching 20 percent in 1998, which helped create a shortfall in the Health Insurance Fund (HIF) equivalent to 19 percent of revenues. In addition, the HIF and public sector health provider institutions accumulated significant debts to suppliers and commercial creditors, amounting to around 3.5 billion denars at the end of 1998.

1.28 **Expenditure cuts in 1999 created a temporary, modest surplus, but the downsizing and structural reforms necessary for financial stability have not taken place.** The HIF reported a fall in expenditure of nearly 15 percent in 1999 over 1998, predominantly from reduced payments to health care providers, cuts in preventative programs and reimbursements, and containment of expenditures on prescriptions for primary health care. Revenues were

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[18] FYR Macedonia does not have any current legislation to govern complex divestments, such as creating self-financing agencies or arms-length entities. At present, the majority of divestments require an amendment to the Law on Organization and Operation of the State Administration, which requires a two-thirds vote in Parliament as it is deemed to be Constitutionally linked.

[19] These included: primary music-ballet schools (247 positions), child creativity centers (72 positions), and workers' universities (72 positions).

[20] 34 regional management positions; telephone operators (18 positions); building maintenance (68 positions); building security (107 positions); cleaning (127 positions); central typing (72 positions); catering (22 positions, plus another 64 to be considered later).

higher, rising by 13 percent, but nearly 4 percentage points were due to one-time assistance for refugees. A modest surplus equal to 3 percent of revenue was reported for 1999, allowing debt repayment and a much lower level of new borrowing. However, it appears that the reduction in HIF debt was offset by an increase in the debts of public sector healthcare institutions (HIs) in 1999. There is also some evidence that patients are paying for a rising share of health care costs in out-of-pocket payments. It thus appears that some of the recent improvement in HIF finances has been achieved by shifting the financial problem to health provider institutions and patients. In 2001, a renewed build-up of arrears has been evidenced (1 billion denars as of October 31).

1.29 **In the early years after independence, piecemeal reforms were selected without adequate consideration of which policy alternatives were most suited to FYR Macedonia's circumstances, or of the implementation issues in a country with very limited public sector capacity**. For example, the shift to dependence on payroll taxes left the health system vulnerable to the subsequent shrinking of formal sector employment. The choice to reimburse providers on an open-ended German-style "points system" proved unworkable, leading to an explosion of claims for reimbursement. This led the HIF to revert to payments against costs of inputs (e.g., wages, consumables, utilities) rather than services provided, which removes incentives for providers to improve efficiency. Thus, the underlying causes of HIF deficits remain: (i) a benefits package more comprehensive than the country can afford; (ii) excessive numbers of doctors, dentists, and support staff; (iii) high prices and little volume control over prescription drugs; and (iv) an inefficient and fragmented network of health institutions.

1.30 **In spite of rapid expenditure growth in 1996-98, the health system does not appear to have offered improved access to basic health services and remains inefficient and inequitable**. Over two-thirds of FYR Macedonians polled in regular opinion surveys over this period report the level of health care services as "bad" or "very bad," and media reports on the effects of the 1999 expenditure cuts on patient care reveal negative public perceptions. Resource distribution is slanted towards secondary and tertiary care in Skopje, while access to basic services in some rural parts of the country is limited and of very poor quality. The network of hospitals and clinics exhibits fragmentation and duplication. Relative to typical EU ratios to population, there are at least 700 surplus doctors and 400 surplus dentists; primary care doctors see only one-fourth as many patients as the EU norm; and the average length of stay in hospital remains markedly higher than in EU or OECD countries. Infant mortality remains twice as high as the CEE average, and high-risk populations have infant mortality rates of 40 or more. Age-standardized death rates for cardio- and cerebro-vascular diseases are 20-40 percent higher than in wealthier neighboring countries (e.g., Greece and Italy).

1.31 The FYR Macedonian health system needs to align the role of government in the health sector with the changing realities of the move to a market-based economy. This has already affected the ability of the health system to raise revenue, obtain supplies, retain some types of skilled labor, and control payments and regulate quality in a growing private health sector. **The Government continues to carry out some roles in the health sector which are not core government functions in a market-oriented economy** and which in many countries are carried out efficiently by the private sector, such as:

- Provision of support services, including hospital "hotel functions" (i.e, catering, cleaning, maintenance, laundry, transport);

- Voluntary supplementary insurance, for inessential health services, or higher levels of amenity in health care;
- Central distribution of pharmaceuticals, equipment and consumables;
- Diagnostic laboratory services, primary health care, retail pharmacies, dentistry, nursing home care, and social care.

1.32 **Privatization is not an easy answer to inefficiency in the hospital system.** For public hospitals, improving incentives, governance and management in an autonomous public agency model would likely be a superior solution to privatization, because hospitals act largely as local monopolies serving geographical catchment areas, and since they provide more complex services which are harder to cost and monitor than the "hotel" services listed above. Instead, private/public partnerships for financing major hospital investment and operating the "hotel services" of hospitals (under "Build-own-operate" contracts) could be considered as an option. Privatization of procurement and of labs, pharmacies, etc., is not straightforward, and should not be rushed. Since these services will continue to be publicly funded, privatization does not eliminate the financial burden on the state; and under current conditions would increase the financial burden on the HIF due to weak regulation and uncontrolled, open-ended payment arrangements for private providers. Adequate regulatory and control systems must be put in place before privatization. The HIF and MOH have, however, made progress in preparing the ground for privatization of primary health care (PHC), by developing a new contract for paying PHC doctors predominantly a per-capita amount for each patient registered with a doctor, combined with some additional incentive payments. This new financing mechanism will allow patient choice and private practice, while retaining overall fiscal control. It will also promote redistribution of doctors, and put downward pressure on doctor numbers. Before privatization of public PHC clinics can take place, organization change and development of management capacity is needed also within public sector medical centers.

1.33 **At the same time, the state needs to strengthen its role in areas critical to a more pluralistic health system and a market economy**:

- Public health regulation and service provision to address externalities (e.g., infectious disease control) and high-risk information asymmetries (e.g., tobacco control);
- Universal, compulsory insurance coverage for basic health services, to address insurance market failures, and subsidization to ensure access for the poor and uninsurable;
- Regulation of the quality, safety and efficacy of medical staff, products, equipment, and processes;
- Facilitation of health information and financial information flows in the health system, to reduce transaction costs and promote public accountability; and,
- Strategic resource allocation measures to target limited resources for health on major preventable health problems, and on populations and individuals in greatest need:

Health Sector: Institutional Reforms

1.34 To address the underlying structural problems and financial imbalances in the health system without compromising access to basic health services, it will be necessary for the Government to undertake a wide-ranging program of reform measures, requiring strong political support. At each level of the health system—from revenue raising through to service delivery—there is a need to review the role played by the public sector and to strengthen the capacity of state institutions to carry out their proper roles. Although there has been public discussion about health reforms of various sorts for several years, and although fear of change is pervasive in the health sector, there has been slow progress in putting reform in practice.

1.35 **The new *Health Insurance Law* (April 2000) provides a foundation for some, but not all, of the reform needed**. It does represent a significant first step on the path to reform. The Law provides a foundation for clearer specification of the basic health services that should be assured by compulsory social insurance. It also provides a framework for improvement in financial management and public accountability of the HIF and the public provider institutions. The Government has already embarked upon a program of reform measures under the new *Health Insurance Law*, and committed to make progress on these over the next two to three years. The reform program includes measures for enhancing budget processes, financial control and accountability; rationalizing co-payments, and improving provider payment arrangements. The following reform measures were completed in 2001:

- Bylaws under the HIL concerning patient co-payments, priority health programs financed by the Budget, new provider payment contract for PHC doctors.
- Bylaws and guidelines for budget preparation and execution for the HIF, including a new Chart of Accounts.
- A model global budget contract for hospitals, including a simple specification of services, and performance indicators.
- Draft legislation for phased privatization of PHC and pharmacy.
- Hospital contracts for 2002 based on the model contract developed for all HIs.
- Budget preparation for 2002 based on the new guidelines.

1.36 However, some additional measures will be needed to fully address the problems of the health sector, both in the short and medium term:

Short-Term Reforms

- Introducing systematic controls for procurement of equipment, supplies and pharmaceuticals in the public health care network.
- Reducing pharmaceutical expenditure through pharmaceutical budget limits for hospitals and a more limited "positive list" of drugs for hospitals and for primary health care which would include low cost generic drugs and more cost-effective brand-name drugs; through replacing generous wholesale and retail mark-ups on prescription drugs with lower fixed-fees for dispensing; and through better procurement and price regulation policies.
- Extending modest co-payments for prescriptions and specialist doctor consultations to a wider share of the population.
- Reducing the number of surplus doctors and dentists in primary health care, using the incentives of capitation payment and private practice. If doctors and dentists worked at typical EU productivity levels (average of 1700 patients per GP), a reduction in the work force of around 700 full-time- equivalent doctors and 400-500 dentists could be achieved.

- Targeting eligibility for some benefits (such as free eye-glasses, prostheses, and orthopedic devices) more tightly to those who cannot afford to pay.
- Gradual reduction in the numbers of hospital support staff and specialists through a freeze on new hiring, filling vacancies through redistribution.

Medium-Term Reforms

- Further enhancing budget processes, financial control and accountability in the HIF, and also in HIs, as discussed in more detail in Chapter 3.
- Rationalizing the hospital network, by reducing the number of hospitals and decreasing lengths of stay.
- Implementing plans for primary health care reform to improve quality (by developing multi-skilled generalist family medicine specialists with a higher level of training), rationalizing distribution of clinics and staff, and improving efficiency (by organizational change and privatization—to complement the financing reforms developed so far).
- Refining over time the new contracting mechanisms for hospitals and specialist services (by improving specification and costing of services) to increase incentives for allocative and technical efficiency, and fair access to services, while retaining capacity for control of aggregate health expenditure.
- Enhancing strategies for the control of the pharmaceuticals bill, especially developing more competitive procurement of drugs and managed privatization of public pharmacies.
- Reviewing contribution rates and sources of revenue, balancing ability to pay against expected use of health services by different classes of insurees.

Social Protection: Issues

1.37 **FYR Macedonia's social programs, which aim to mitigate a growing incidence of poverty and persistent high unemployment during transition, are costly**. The public pension system, unemployment insurance, and social assistance programs generate expenditures (including health insurance) equivalent to nearly a third of GDP and comprise over two-thirds of public spending.

1.38 **The efficiency and effectiveness of these social protection programs are low**. Social assistance is still not well targeted, despite recent improvements in means testing; inclusion errors are high, partly due to weak administrative capacity for monitoring. Even those programs that were designed to be self-financing through contributions require budget transfers or other extraordinary financing on a regular basis, and actual expenditures are consistently higher than original budgeted levels.

Pension System

1.39 Pension payments are the largest social transfer, equaling 8.2 percent of GDP in 2000 and a projected 8.6 percent of GDP in 2001, a level of expenditures similar to those in Hungary and Croatia, countries whose GDP per capita is 3.5 times higher. The pension fund has faced financial difficulties due to a decline in contributions, a generous benefit structure and eligibility conditions, as well as the aging population. The amendments to the *Law on Pension and*

Disability Insurance (passed in March 2000) have greatly strengthened the financial soundness of the PAYG pension system for the long-term.[21] Pension age will continue to be increased, pension indexation will be reduced, and the replacement rate will be cut further. A mandatory, fully-funded pension 'pillar' is to be introduced very gradually, in coordination with the downsizing of the first 'pillar', the PAYG system. As a result, a 2 percent of GDP deficit[22] estimated for the PAYG system for 2000 is projected to improve gradually. Nonetheless, serious fiscal and policy challenges remain.

Unemployment Insurance

1.40 **Unemployment expenditures are very high,[23] not just because of the country's high rate of unemployment, but primarily because of the generous benefit structure and contributions transferred to other welfare programs on behalf of the unemployed.** Only about 10 percent of the unemployed are eligible to receive benefits, but if eligible, beneficiaries receive 50 percent of their average wage for the first 12 months and 40 percent for the next 6 months. Unemployment has proven exceedingly difficult to push below a rate exceeding 30 percent[24], while further layoffs are expected in connection with planned closures of large loss-making enterprises and the downsizing of the public administration. As the number of employed workers has fallen, the 1.5 percent payroll tax has proven insufficient to finance the Employment Fund, providing about 20-30 percent of revenues; the remainder comes as transfers from the central government budget. In addition, the system has recently been running 2 months in arrears to beneficiaries. With total program expenditures around 2 percent of GDP in 1999 and 2000 (including contributions to other funds), the program does not significantly affect overall fiscal balance.

Social Assistance Programs

1.41 These means-tested programs provided cash benefits to more than 78,000 low income households in 2001, costing about 1.4 percent of GDP, a level comparable to most countries in the region. However, several problems persist with respect to loose eligibility criteria, poor poverty targeting, and weak financial management and information systems.

Social Protection: Reforms

Pension System

1.42 The new Pension Law establishes mandatory funded pensions that are intended to act as a second 'pillar' to the pension system (with the PAYG system as the first pillar), aiming to increase incomes of the elderly while ensuring financial sustainability of the system. The funded pillar will require participation for all new labor market entrants, while offering voluntary

[21] Increasing the pension age to 63 for men and 60 for women, with further increases under consideration; enforcing age exclusive retirement conditions; changing pension indexation rule; redefining minimum pensions; reducing the replacement rates of disability pensions; and reducing the replacement rate.

[22] The deficit used here is the difference between designated payroll tax revenues and standard pension benefit expenditures. Following the narrow definition of pensions used by the pension reform steering committee where veteran and agriculture pensions are excluded, the deficit level was about 1.2% of GDP.

[23] In 2000, 1 percent of GDP was paid directly to eligible unemployed. Over 1.4 percent was spent in transfers to the health and pension funds to pay for insurance contributions on behalf of beneficiaries.

[24] According to the Labor Force Survey the unemployment rate was 32.2 percent for 2000. Administrative records of the National Labor Office indicate an increase in the number of registered unemployed during 1999 and first months of 2000, *although these data are distorted by incentives to register in order to get health and pension insurance.*

participation to all current contributors. The individual pension accounts will be funded by 7 percent of payroll, while the remaining 13 percent of gross wages continues to go to the PAYG scheme. The replacement rate from the PAYG pillar will be reduced to about 30 percent for those with 40 (men) and 35 (women) years of service. The pension that individuals receive at retirement will consist of the pensions from the PAYG pillar and the accumulation plus investment return on the funded second pillar. Developing this new system will require the role of the state to change in old age income provision. It will shift from the sole provider of old age pensions to a partial provider, a regulator, and to certain extent, a guarantor. In the meantime, individuals will assume more responsibilities in managing their income and investment.

1.43 Transition to the multi-pillar system will place some fiscal pressure on the PAYG system as shown in Table 1.4, but the rules for transition to the multi-pillar system were designed to control costs and to allow time for financial markets to mature sufficiently. The total pension system deficit will likely be less than 1 percent of GDP in the initial year of reform and decline to zero in about three years.

Table 1.4: Projection of the Pension System Balance, Percent of GDP[25] (Using Narrow Definitions[26])

Year	Difference between contributions and pensions in PDF	II pillar contributions	II pillar assets
2004	-0.9	0.8	0.8
2005	-0.7	0.9	1.5
2006	-0.1	0.9	2.4
2007	0.2	1.0	3.3
2008	0.3	1.1	4.4

Source: MLSP projection, 2001.

1.44 Successful implementation of this fundamental reform of the pension system depends on a healthy macroeconomic environment, a sound financial sector, adequate institutional infrastructure and strong administrative capacity, as well as a conducive political environment. Reform priorities in the near and medium-term will include:

- Parliament to approve the law on private pension funds ('second pillar') to govern operation of the funds. The supervision agency will need to be established shortly after the Law is adopted.
- Further develop financial markets and create a public debt market.[27] Given problems with the stock, real estate and insurance markets, the establishment of Treasury securities and attraction of limited international investment would be positive steps.

[25] This projection assumes that male current workers younger than 36 and female current worker younger than 32 would choose to switch to the new scheme, and that most of the switching would take place starting in 2004.

[26] This presentation follows the narrow definition used by the pension reform steering committee and presented in the report to the Government. That is, *contribution* includes contributions based on wage, income, and that from private sector and farmers; *Pension expenditure* includes old age, disability and survivor pensions, and some other special pensions required by the state. Another way to examine the financial situation of the Pension Fund is to categorize both the revenue and expenditure according to the financing obligations stipulated in the laws and regulations. For example, if the narrow definition of revenue (contribution) does not include general budget transfer, then the narrow definition of expenditure would also exclude the special pensions which are financed by the budget. Projection based on such definition is also carried out by the Actuarial Unit of the MLSP.

[27] For an in depth discussion, see Annex 1.2.

- Strengthen the capacity of the Public Pension Fund, by improving information management and administration.

Unemployment Insurance Program

1.45 The Employment Fund has experienced serious financial difficulties in meeting its commitment to provide income support to qualified registered unemployed and depends on transfers from the central budget to cover over 75 percent of program expenditures despite its design as an insurance program funded by contributions. The depressed labor market has exacerbated this problem. The short-term focus of reforms should include:

- Improve the administration of the unemployment benefit program by strengthening enforcement, monitoring, information systems, financial management and internal control;
- Expand policy analysis of the labor market, the impact of structural reforms of private and public sectors, issues regarding cross program linkages, and further reform of unemployment assistance programs.

1.46 In the medium term, several issues need to be considered in order to strike the right balance between promoting a competitive labor market and protecting the unemployed.

- Reform the *Labor Relations Law* to make it more compatible with the development of a market economy.
- Adopt further measures to improve the business environment and increase labor market flexibility; e.g., continue simplifying the requirement for hiring and firing workers; significantly reducing maximum severance payments.[28]
- Further rationalize unemployment benefit policy and improve benefit coordination across social welfare programs.

Social Assistance Programs

1.47 Social assistance programs also need to address several medium-term policy and administration issues:

- Tighten eligibility and enforcement for social assistance (e.g., through stronger asset testing), as set in the 1998 social assistance decree[29].
- Improve poverty targeting for the existing child allowance program.
- Develop Social Investment Fund type programs that encourage community participation to assist the poor.
- Improving program administration and benefit delivery. Budgeting, financial management, information management, administrative capacity, and human resource allocation need to be improved.

[28] Instead, the government introduced in 2000 a generous severance pay policy for the public sector by granting every laid-off public sector employee the maximum duration. This is fiscally imprudent, given FYR Macedonia's tight fiscal situation, and difficult to justify on equity, efficacy or efficiency grounds.

[29] The threshold of benefit is being reduced over time (to 70 percent for the third benefit year and 50 percent for the fourth year). The reduction in benefit to 70 percent started in 2000 and is likely to affect one third of the recipient families. Also, after receiving benefits for four years, individuals will lose benefit rights for two years.

CONCLUSION: FISCAL STABILITY WITH INSTITUTIONAL AND STRUCTURAL REFORMS

1.48 **This chapter has underscored the need for a medium-term, sustainable fiscal strategy that incorporates both institutional and structural reforms and a realistic response to unbudgeted commitments.** An attempt is made below to illustrate how budget composition would be affected if these reforms proceeded.[30] The following chapters outline in detail a phased strategy for delivering the necessary institutional reforms in the medium term, as well as the Government's accomplishments to date.

1.49 The scenario used here assumes economic growth of 6 percent in the medium-term with low inflation, a stable currency, and fiscal deficits of no more than 1 percent of GDP. Better control over spending and rationalization of social programs will allow the private sector to expand more rapidly. Supported by increasing domestic savings rates, both public and private, fixed investment could rise from 19 percent of GDP in 2000 to around 26.5 percent of GDP in 2005, encompassing a 5.2 percentage point increase in private investment and a 2.3 percentage point increase in public investment. With rapid expansion of production, employment would increase and the rate of unemployment could drop from 33 percent in 2000 to around 22 percent in 2005. (See Table 1.5.) Obviously, for this to occur, the 2001 downturn related to the security crisis must be viewed as an aberration.

Table 1.5: Fiscal Projections with Reform (in % of GDP)

	1998	1999	2000	2005
Total Revenue (1)	33.3	35.4	36.8	37.3
Total Expenditure (1)	35.0	35.4	34.3	38.3
Goods and services	11.7	11.7	10.2	11.5
Wages and salaries	8.5	8.8	7.2	5.3
Subsidies	0.1	0.1	0.2	0.0
Unemployment benefit	1.1	0.8	0.8	0.4
Social assistance program	1.3	1.5	1.5	0.9
Pension and disability	9.2	8.6	8.2	7.3
Capital expenditure	1.8	2.3	2.7	5.0
Structural reforms	0.0	0.0	0.1	0.0
Administrative reforms	0.0	0.0	0.0	0.0
Other	1.4	1.6	3.4	7.9
Balance (accrual)	-1.7	0.0	2.5	-1.0
Memorandum:				
Frozen foreign currency deposits	0.0	0.0	1.7	1.1
Privatization of Stopanska Banka	0.0	0.0	0.2	0.3

(1) General Government

(2) Source: World Bank

[30] See Annex 1.2 for detailed assumptions for this scenario.

1.50 The proposed budget composition (2005) further assumes that progress in addressing the problems identified earlier in the chapter will be achieved. These include[31]:

- The wage bill, and overall employment levels will decline to a more affordable level --5.3 percent from the current 7.2 percent.
- These reductions will be achieved through restructuring government by eliminating non-core activities.
- The wage bill savings will be sufficient to accommodate salary decompression.
- Reforms in social protection will proceed, with the resulting program efficiencies enabling a reduction for pensions from 8.2 percent to 7.3 percent of GDP; unemployment from 0.8 to 0.4 percent of GDP; and social assistance from 1.5 to 0.9 percent of GDP.
- Health sector reforms proceed so that additional fiscal pressures on the comprehensive budget do not crowd out other priority needs (e.g., capital expenditures).
- A significant increase in capital expenditures will occur to reverse years of underfunding, almost doubling from 2.7 percent to 5.0 percent of GDP;
- Compensation will continue to be provided to pay the owners of frozen foreign currency accounts, and the recapitalization of Stopanska Banka, through a 15-year government bond, will cost the budget between 0.2 and 0.4 percent of GDP in 2001-2005.[32]
- Additional spending will be needed to support essential structural and reforms such as the sale or liquidation of major loss-making enterprises, including severance payments, unemployment benefits and wage arrears to workers who lose their jobs; a first round of restructuring involving the nine largest loss makers alone could cost the budget 0.2 percent of GDP in the first year if 30 percent of the employees are laid off.
- Revenue impacts of changes in tax policy (e.g., decreased payroll tax) will be offset by improvements in compliance.

[31] Other costs will arise from the recently concluded Framework Agreement (August 2001). However, the magnitude of the costs as well as the timetable for the implementation of the Framework Agreement remains uncertain at this point.
[32] In 2000, it cost the Government 0.21 percent of GDP.

2. POLICY FORMULATION

INTRODUCTION

2.1 The previous chapter described FYR Macedonia's accomplishment in sustaining fiscal discipline since the mid-nineties and further elaborated how this stability had been achieved through short-sighted fiscal adjustments, which put that very fiscal stability at risk over the medium-term. A medium-term fiscal scenario for FYR Macedonia was then offered to illustrate how fiscal stabilization can co-exist with fiscal and structural reforms. To realize this objective, however, the Government will need to strengthen significantly its policy formulation capacity.

2.2 At the government level, effective policy formulation relates only in part to the quality of individual policy proposals. More important is the effective management of the overall policy process where a complex range of policy commitments must be carefully prioritized and translated into affordable, coherent programs. Governments that chronically break or find themselves unable to deliver their commitments are much less likely to be able to implement successful economic reform.[33] There is evidence that FYR Macedonia experiences problems in this regard.

2.3 An indicator of whether a country enjoys a predictable policy environment is set out in Table 2.1. This illustrates how FYR Macedonia, like other CEE countries, encounters a credibility gap with respect to the perceived reliability of its policies by the business community. **The consequences of this high level of policy unpredictability undermine the credibility of the government, deter investment, and hamper economic growth**. This business survey illustrates a worsening situation in FYR Macedonia between 1996 and 1998. Presumably the 1999 Kosovo and 2001 security crises, which not surprisingly were accompanied by sharp declines in foreign direct and fixed domestic investment, have exacerbated this negative trend.

2.4 To delve into the underlying causes of FYR Macedonia's policy reliability problem, this chapter will review four common constraints to predictable, coherent policy formulation:

[33] Using the assumption that the budget is the key vehicle by which governments deliver their promises, World Bank research (Knack, Eng, Kugler) examined multi-year budget data from 83 countries and found that successful economies typically had lower budget volatility; i.e, the gap between approved and actual resources. For example, the three lowest scores were United States, Switzerland, and Denmark. The three highest were Democratic Republic of the Congo, Madagascar, and Vanuatu.

Table 2.1: Policy Reliability: Survey of the Business Community (in %)

	FYR Macedonia 1996	FYR Macedonia 1998	High Income OECD 1996	Czech R., Slovakia Hungary, Poland 1996	Balkans (2) 1996
Laws or policies which materially affect business are highly to completely unpredictable	20	34	7	20	29
The Government is seldom or never expected to stick to major policies	14	28	10	22	30
Affected businesses are seldom or never informed of the process of developing new rules or policies	34	39	22	52	45
The government seldom or never takes into account concerns voiced by business	60	63	29	64	53
Business community fears retroactive changes of regulations to the detriment of their business operations	18	29	12	16	40
In the last ten years predictability of laws and policies has decreased	16	19	30	31	37

(1) Percentages were arrived at by adding the 2 worst scores of each question.
(2) Albania, Bulgaria, FYR Macedonia, Turkey.
Source: World Bank Development Report, 1997.

- First, the Executive's ability to develop and reliably implement policy commitments can be constrained by the country's *political institutions* when they weaken the collective decision-making process.[34]
- Second, the quality of policy formulation through the budget can be adversely affected by *lack of capacity* in key central agencies.
- Third, *budget process constraints* can create obstacles for policy makers in planning coherent, realistic budgets.
- Fourth, *budget fragmentation,* which occurs when key decisions affecting the budget are taken outside the annual budget process, can undermine comprehensive fiscal policy. Examples include: special revenues, unauthorized guarantees, extra-budgetary funds, use of external financing and cash rationing during budget execution.

POLITICAL INSTITUTIONAL CONSTRAINTS

Incentives for Collective Decision-Making

2.5 The initial analysis of FYR Macedonia's political institutions found few intra-executive constraints to coherent policy management. In fact, the Government's decision-making system[35] lent itself to collective decision making and provided its members with strong incentives to work within the forum of the weekly Government meeting. However, external pressures are more

[34] No judgment is made on the appropriateness of the political institutional arrangements; the impacts of these arrangements on the Government's budget policy capacity are simply observed.
[35] In FYR Macedonia, the term Government describes what in other systems would be called the Cabinet or Council of Ministers

pronounced. The fragility of coalitions and a tradition of strong parliamentary influence confront the Executive with a high exposure to dismissal, high probability of defeat, and high likelihood of major changes to key reforms; the difficulty in reforming pensions has provided one example.

Table 2.2: The Role and Perceptions of the Government

Rules of the Game		Setting Major Government Priorities		Making Choices within Priorities
Incentives to negotiate	+	Government viewed as exclusive decision-making forum	+	Definitive fiscal framework (by IMF) prepared prior to budget finalization
	+	Government agrees to aggregate expenditure cap	+	Ministries bound by spending limits during budget execution
	-	Poor quality, single-year fiscal forecasts		
	-	Priorities not set within context of a fiscal plan	-	Tenuous linkage between approved budget and legislative/policy priorities
	-	Process and information gaps diminish potential for informed trade-offs	-	Results assessments by ministries not required
	-	Legislative program established with poor anticipation of veto points (parliament, constitution)		
	-	No program review capacity		
Credible, enforceable rules	+	Prime Minister is able to dismiss Ministers (within constraints of coalition)	+	Prime Minister is obliged to take ministers' views into account
	-	In past, no indication provided as to how fiscal forecast affects budget process (will change with new 2003 process)	+	Ministries have exclusive responsibility for developing policy and legislation
	-	No implicit or explicit rules on determining budget allocations or expenditure reductions (will change with new 2003 process)	+	Guidelines exist on identifying financial impacts (introduced in 2001, not yet effectively monitored)
	-	Ministries not provided with preliminary allocation targets (will change with new 2003 process)	+	Policy/legislative approvals cannot be obtained without guarantee of funding (introduced in 2001, not yet effectively monitored)
			-	No guidelines exist on policy impact analysis
			-	Limited authority of central agencies to turn back poor quality or poorly costed submissions or laws
			-	Budget was not reliably provided in 2001 (largely owing to security crisis)
Realistic prospect of agreement	+	Ministers participate in budget finalization discussions at Government meeting	+	All significant fiscal, policy and legislative decisions are routed through Government
	+	IMF agreement on aggregates obtained prior to finalization		
	-	Bilateral budget negotiations undertaken in absence of known limit		

Note: the + sign refers to strengths and the – signs refers to weaknesses.

2.6 Table 2.2. sets out several key factors in the FYR Macedonian context that create or inhibit incentives for decision-makers to participate meaningfully in collective decision-making. In this analysis, the majority of positive indicators derive from FYR Macedonia's strong predisposition to collegial government and adherence to the fiscal limits advocated by the IMF.[36] Weaknesses primarily relate to the lack of analytic support and co-ordination among the central agencies and those gaps identified under allocative efficiency, in particular the de-linking of the policy and fiscal processes. **Given the severity of these disincentives to government cohesion, the fact that a strong collective decision-making structure prevails in FYR Macedonia suggests that process and capacity improvements can be implemented effectively within existing structures.** Medium-term recommendations on the organization of the Government are presented in Annex 2.1.

2.7 Although the 2001 security crisis will clearly affect the political institutions of FYR Macedonia, it is too early to assess the impact of implementing the Framework Agreement. It is

[36] *Although the IMF program went off-track during 2001, a Staff Monitoring Program was endorsed in December 2001*

likely, however, that collective decision-making within government will remain the pre-eminent decision-making forum.

Policy Management Structures

2.8 Although the number of ministries or parliamentary committees does not inevitably affect the quality of decision-making, the trend throughout EU accession countries has certainly been towards a smaller number on the basis that more coherent reviews of policy issues can be achieved. FYR Macedonia has followed this trend in the executive, but not the legislative branch.

- *Executive Branch.* With 14 ministries (streamlined in 2000 from 21 ministries), FYR Macedonia's Government is comparable to others in central and eastern Europe. By comparison, Bulgaria has 13 ministries, Czech Republic 19, Estonia 14, Hungary 16, Latvia 12, Lithuania 7, Slovakia 15, Slovenia 16, and Romania 19.[37] The focal point for decision-making is the weekly government meeting, attended by all ministers and senior officials from the General Secretariat. To support the government, FYR Macedonia uses a government committee system comprising standing committees and special committees. As President of the Government, the Prime Minister enjoys the pre-eminent role in the decision-making process. This authority is both explicit and implicit.
- *Government Committees.* Government committee systems are fundamental to ensuring inter-ministerial policy co-ordination. The large majority of government systems use a committee structure to resolve disputes prior to and relieve pressure on the formal government meeting. There are numerous variants of government committee systems ranging from highly structured (Bulgaria, UK) to virtually non-existent (Moldova, Ireland). In terms of policy reliability, the key issues relate to the system's capacity to provide strategic direction, policy co-ordination, policy analysis, and fiscal review. FYR Macedonia's government committee structure includes two standing committees dedicated to broad policy fields and five special committees (e.g., Euro-Atlantic Integration, Privatization). With the implementation of process improvements, the committee structure should fulfill the policy co-ordination and analysis roles. There is less presence of the strategic and fiscal review functions.[38]
- *Legislative Branch.* There are 24 parliamentary committees (compared to 13 in the Czech Republic, 10 in Estonia, 16 in Latvia, 22 in Hungary, 18 in Slovakia, and 12 in Slovenia). The Finances and Budget Committee plays two key roles: reviews the budget; reviews the financial implications of individual laws. With

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[37] Drawn from the SIGMA Public Management and Center of Government Profiles.

[38] Typical options to augment strategic planning include a dedicated committee chaired by the Prime Minister (e.g., strategy committee in New Zealand; strategic policy and communications in Ontario, Canada), expanding the mandate of financial or sectoral committees (EDX committee in UK, economic committee in Hungary), or assigning the role to full government (Denmark). In coalition governments, party representation may complicate the creation of a strategic planning committee; note that such structures do not exist in central and eastern Europe. Nonetheless, FYR Macedonia's situation, where the lead party holds a large majority of government posts, does not preclude this option. Regarding fiscal review, separate committees dominated by central ministries have been used to review the cost-benefit and detailed fiscal implications of individual initiatives (Canada, Australia) or oversee special cost-cutting exercises (Star Chamber in Britain). Given the lack of sophistication of the Macedonian financial system, it is likely too early to consider a dedicated committee for fiscal review. Instead, augmenting the role of the policy committees in this regard may be a more practical measure. Britain's EDX committee model presents one option for providing government oversight of the results of a functional review

respect to assessing the financial implications of new laws, the committee relies on the financial statement provided by the government that accompanies the draft law. The Government recently introduced mandatory fiscal impact analysis for all proposals proceeding for consideration at its meeting. In the past, the sponsoring ministry typically identified that there were no financial impacts to their proposed legislation. The mandatory fiscal impact analysis system has not yet been effectively implemented.

LACK OF CAPACITY IN CENTRAL AGENCIES

Policy Management Role of Central Agencies[39]

2.9 The quality of decision-making at the centre depends, to a large degree, on the quality of support provided by the public service. In particular, central agencies that support the Government's strategic policy, fiscal planning, and human resources management functions are critical in this regard and play important quality assurance and co-ordination roles. Typically, they provide the Prime Minister and the Government with an alternative source to line ministries for options and analysis, often from a global rather than a sectoral perspective.

2.10 To play this role effectively, central agencies need to be viewed as elite, albeit accessible organizations able to access information from ministries. Incentives for ministries to cooperate include information sharing (central agencies can connect them with other ministries) and career path aspirations (a cabinet office/chancellery posting is often considered the pinnacle of a civil servant's career).

2.11 In the financial realm, the same principle applies to select positions in the Ministry of Finance. FYR Macedonia's central agencies will be assessed in terms of their individual and collective effectiveness. This latter role is particularly important as it is here that the domains of policy, finance, and human resources intersect. Deficiencies in one area will adversely affect the others.

General Secretariat

2.12 The key organisation supporting the central decision-making process is the General Secretariat. In FYR Macedonia, the approval in 2001 of the new *Rules of Procedure of the Operation of the Government of the Republic of* Macedonia formally differentiated the administrative functions normally associated with a prime minister's office and cabinet office. The General Secretariat is headed by the General Secretary who is deemed to be the top civil servant, although appointed by the Government. For a more detailed presentation of the General Secretariat's role and staffing, see Annex 2.1

2.13 Like many offices directly supporting the machinery of government in Eastern Europe (e.g., Lithuania), the focus of the General Secretariat's interaction with the decision-making process has largely been confined to administrative support and legal analysis. Absent is a strong role in ensuring the coordination of complex horizontal issues and in providing an

[39] For a detailed presentation on budget institutions, see Annex 2.3.

alternative to line ministries for policy options and analysis. The following observations on the operation of the Government meetings and the preparation of material applied in 1999/2000:

- Virtually no financial information was provided; ministries routinely claimed that there was no cost to the draft legislation that they proposed, but ultimately there were costs;
- The Ministry of Finance did not sign off on ministry costings;
- Options were seldom provided, or examples from other countries;
- No policy impacts or political analysis were provided;
- The explanatory material accompanying legislation was too long for ministers, with no standard format or executive summary;
- Too many minor issues were brought forward; many of these should have been resolved bilaterally;
- Not enough lead time was provided to review material, which usually arrived 2-3 days before a decision meeting;
- No codified standards nor "how to" manuals existed to guide ministries in the preparation of policy or fiscal impact assessment;
- Consultation time frames for legislation were often very short; e.g., complex health legislation only allowed ministries 10 days for comments; and
- Unrealistic targets for passage of legislation were common, although considerable effort was made by the General Secretariat to ensure ministries adhered to the deadlines contained in "*The First 100 Days*"[40].

2.14 These observations suggest two key problems that needed to be addressed regarding the role and authority of the General Secretariat:

- The role of the expert and republican advisers in reviewing line ministry proposals was too narrowly defined as it does not include generating additional options or providing impact assessments; and,
- Insufficient gatekeeper authority had been delegated to enforce the rules set out in the *Rules of Procedure*.

2.15 During 2001, the General Secretariat attempted to address these problems; first, by obtaining approval for new *Rules of Procedure* and, second, by receiving approval for a strategic plan that will change the organization's mandate and structure. This shift in purpose of the General Secretariat to a more proactive, analytic organization will, if successfully implemented, improve the quality of information presented to the Government and reinforce the benefits that will be gained with the implementation of a fiscal impact assessment methodology and the new 2003 budget process.

2.16 These changes, which will strengthen the capacity of the General Secretariat, should not be viewed as undercutting ministerial authority for developing sectoral policy. Ultimately, the ability to produce real alternatives and quality analysis must become resident in line ministries. Nonetheless, the General Secretariat can play a key role in ensuring that ministers are provided with the full range of options and a clear sense of impacts when they are confronted with policy choices. The expansion of this role would build on existing strengths in the General Secretariat,

[40] The Government's program, drawn from the campaign commitments, for the first 100 days of its mandate.

such as their legal review capacity, demonstrated leadership in co-ordinating European integration issues, and monitoring system for assessing progress in delivering the government program. It is hoped that the new *Rules and Procedures* and the General Secretariat's strategic plan will set the stage for strengthening these critical competencies.

2.17 The staffing complement in the General Secretariat (120) approximates that of similar organisations in Albania, Bulgaria and Lithuania.[41] At a cursory glance, this level does not raise any under or overstaffing concerns. This suggests that the recommended shift in mission can be accomplished within existing resources. However, there may be a need to replace staff who do not have or are not able to acquire the necessary skills to support the General Secretariat's new role.

Ministry of Finance Budget Department

2.18 The Macroeconomic Balances and Models division was relocated to the Ministry of Finance from the former Ministry of Development in 2000.[42] It is responsible for producing the economic forecast that is used as the basis for the macroeconomic report presented by the Ministry of Finance at the outset of the budget process. The Ministry of Finance also assumed responsibility for preparing the 3-year Public Investment Plan [PIP]. The most recent approved plan ran from 1999-2001 and was prepared by the Ministry of Development, whose role was primarily canvassing and coordinating ministry proposals. Although the Government did approve the PIP, only a fraction of the plan was ever reflected in the budget that was prepared by the Ministry of Finance and approved independently of the investment plan. As the Ministry of Finance did not play a role in compiling the PIP, it was not referenced when capital cuts were imposed during the year to maintain the overall deficit target. It remains to be seen whether the consolidation of the PIP role in the Ministry of Finance will result in a more coherent, feasible capital plan.

2.19 The Ministry of Finance's budget department performs a wide variety of functions connected with every stage of the budget process. With 15 staff in December 1999, this department was severely under-staffed by any standard of comparison. For instance, Lithuania has 54 staff in the budget department and 13 in a separate fiscal planning department. In Bulgaria, the budget department has 120 staff. Throughout 2001, additional staff were hired to strengthen this area.

2.20 The new budget process, approved for 2003, and the requirement for mandatory fiscal impact assessments places new demands on the budget department. To prepare for this shift, the ministry has completed an organizational effectiveness review to assess ministry organisation, inter-departmental linkages, management bottlenecks, and skills/training requirements.[43]

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[41] It is difficult to determine appropriate size. Britain for instance has 100 staff in its Cabinet Office, Germany 453 in its Chancellor's Office [N. Manning; Strategic Decision-Making in Cabinet Government; op. cit.]. In this example, though, the four government offices deliver similar functions.

[42] The Ministry's functions were reallocated (primarily to Finance) during the 2000 Ministry restructuring.

[43] EU PHARE's extensive re-engineering project with Bulgaria's Ministry of Finance suggests the scope of review that is required in FYR Macedonia. Organisationally, models that separate some of the functions could be considered. Many organizations separate at least two and often all of the fiscal planning, budget and treasury functions. Within the budget department, some combination of overarching and sectoral units may be appropriate. Both Sweden and Germany follow this model where divisions are dedicated to ministries or ministry clusters with others assigned to cross-cutting issues such as fiscal planning, budget

Coordination Across Central Agencies

2.21 Central agencies share co-responsibility for integrating policy, fiscal and human resources issues. The perpetuation of central agency silos adversely affects policy and fiscal outcomes. Policies or laws that are approved without proper assessment of multi-year financial implications suffer in the implementation stage. Budgets that ignore the policy priorities of the government are likely to be circumvented. An organisation's approach to recruitment, compensation, and training can significantly affect the overall quality of policy development, financial management, and program implementation.

2.22 As in the former Soviet states, FYR Macedonia faces the challenge of building its central agency relationships, if not from scratch, from an early stage of development. In fact, the progress made by the General Secretariat in terms of EU co-ordination is quite laudable given the short period of its existence as a national body. Not surprisingly, the degree of policy/fiscal/human resources integration among the supporting organisations remains low:

- The Ministry of Finance does not have any involvement in developing the legislative program; and the Ministry is just beginning to play a role in reviewing ministry costing of policy proposals to be submitted to the Government.
- The General Secretariat plays a minor role in analysing and presenting the budget to the government;
- The government's public administration strategy is supported by a small division in the Ministry of Justice which does not play any role whatsoever in terms of contributing to the government's evaluation of the budget or individual policy initiatives; and
- The creation of an independent Civil Service Agency may result in better linkages in the future, but their current preoccupation is with systematization across government and the implementation of secondary legislation.

2.23 Effective central agency integration, admittedly elusive to many developed countries, remains a long way off in FYR Macedonia (see Table 2.3). Positively, plans to begin the process of strengthening these linkages have been approved. In the medium-term, a co-ordinating mechanism to link the forecasting, budget, policy and human resources functions should be established. These mechanisms may involve central agency senior management committees, a new cross-cutting government committee, new formats for preparing analytic material for the Government, and working groups with expert staff from each area. Such coordination is required at all stages of the strategic priority-setting, budget and legislative processes. Without effective integration, the decision-making system will lack several essential pre-conditions for policy reliability. The influence of the central agencies in creating an environment where this can be achieved should not be underestimated. The General Secretariat is perhaps in the best position to assert leadership to the integration and coordination of central agency functions.

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methodology, or the European Commission. Such structures could of course only be contemplated following a major restructuring of the budget function.

Table 2.3: Stages of Development for Four Key Central Agency Functions

Function	Organization	Stage of Development 1999	2001
Forecasting	Ministry of Finance	2	3
Policy	General Secretariat	4	4
Budget	Ministry of Finance	2	3
Human Resources	Ministry of Justice/Civil Service Agency	1	2

0=non-existent, 1=inception; 5=performs all basic functions 10=fully-integrated

PROCESS GAPS IN BUDGET FORMULATION

2.24 Given limited resources, governments must make choices among competing alternatives. A cornerstone of executive accountability is that strategic priorities will be articulated to guide those choices within a sustainable fiscal plan.[44] While a multitude of approaches exist, there are several critical success factors that should be resident in any strategic priority-setting approach:

- a realistic macroeconomic/fiscal framework must be provided;
- priorities must be well articulated;
- the planning horizon must extend to the medium-term;
- approved budgets must be reliably provided; and
- the approved priorities must be publicly articulated so that results can be gauged transparently against commitments.

Realistic Fiscal Framework

2.25 The start point of effective budget formulation is the establishment of a reliable and realistic fiscal framework. This framework links macroeconomic, revenue, expenditure, and deficit projections to establish an aggregate expenditure limit within which policy decisions can be taken . Otherwise, **little incentive exists for ministers to pare down their demands to an affordable level or to make any trade offs whatsoever.** Typically, failure to impose discipline at this early stage (e.g., inflating revenue forecasts to meet desired expenditure levels) carries through the budget formation process. Table 2.4 gives an indication of the level of reliability of GDP growth estimates in FYR Macedonia.[45]

[44] There is no standard approach to setting strategic priorities. Priorities may be expressed as high-level themes (e.g., combating corruption, eradicating poverty), objectives (increase literacy to x percent), and/or major initiatives (lower income taxes, reform the criminal code). Priority-setting can be additive (areas of new expenditure) or subtractive (areas for expenditure reduction). Early stages of development of priorities involve a top-down approach. As policy formulation evolves, room for bottom-up increases. In Denmark, the government holds semi-annual Cabinet retreats to review long-term planning issues, policy themes, budget priorities, and the Prime Minister's Annual Opening Address to Parliament. New Zealand's Strategy Committee, chaired by the Prime Minister, meets year round to ensure that budgetary and policy objectives are aligned. Budget preparations begin in France a year in advance with an outlook exercise in which the macroeconomic forecast is used to derive an expenditure scenario which is then adjusted to reflect major political commitments. This establishes the "room to manoeuvre" for the succeeding budget exercise. In Canada, Cabinet reviews all proposals for additional expenditures against a fixed amount allocated for new initiatives by the Ministry of Finance. Australia stipulates that any ministry proposal to increase spending be accompanied by an offsetting proposal to produce savings. This leaves Cabinet free to focus on strategic decisions; i.e., determining, for those items with high political or fiscal consequence, the optimum mix of new, expanded, or eliminated policies or programs given macroeconomic constraints.

[45] The growth and revenue forecasts underpinning the budget submitted to Parliament later in the year were agreed to by the IMF and typically would vary significantly from the initial estimate prepared in the Spring.

2.26 **Forecasting unpredictability has been further exacerbated by external factors such as the 1999 Kosovo crisis and the 2001 security crisis.** When revenue targets have not been achieved, progress in controlling the central government deficit has been achieved through cash rationing rather than planned expenditure cuts as discussed before. Although this has maintained fiscal discipline, it has affected the predictability of funding and the quality of service delivery. In addition to the impact of the crises, weaknesses in the macroeconomic and fiscal frameworks can be attributed to several factors:

- The limited quality of forecasting methods: data gaps, trend analysis, capacity issue.
- Short-term horizon (1 year).
- The focus and accuracy of fiscal planning.[46]
- The limited quality of expenditure estimates.
- Revenue projections are prepared by three units and first appear in the Ministry of Finance's July report to the Government. The forecasts use historical information (up to 3 years back) and YTD data to project levels for the remainder of the current year.
- There is no fully established system for the analysis of the debt sustainability in the NBRM.[47]

Table 2.4: GDP % Growth Estimates vs. Actual

	1997	1998	1999(1)	2000	2001
March Forecast	5.0	5.0	6.0	7.0	2.0
Actual	1.7	3.4	4.3	4.3	-4.6

(1) 1999 was marked by the unexpected Kosovo crisis.
Source: Ministry of Development

2.27 To the extent that both the IMF and the Government are involved in finalising the budget late in the year, the Ministry of Finance does not yet own the process. Thus, **incentives for the initial forecast tilt more towards appeasing immediate political pressures than realism and technical proficiency.** The tendency to overestimate revenue stems from: (i) the open-ended

[46] The focus of fiscal planning covers the Central Government's budget flows (cash basis) only. Fiscal planning explicitly estimates budget implications for the pension fund scheme and for social security schemes. However, these estimates provided by the Pension Fund are not based on data by the Actuarial Unit and some discrepancies are found for example in the net increase of pensioners per year (2.4 percent estimated by the Pension Fund against 1.5 percent estimated by the Actuarial Unit). Data used for forecasting the number of beneficiaries of social assistance also tend to be subject to unexplained variations.

[47] The National Bank of the Republic of Macedonia keeps records of the total public external debt. The total long-term and medium-term external debt is recorded on a regular basis. Semi-annual and annual reports are prepared on the stock of the external debt which includes the debt to multilateral and bilateral institutions and some portion of the debt to private creditors. The External Debt Department at the National Bank prepares a plan for the future debt payments, periodically prepares several debt ratios according to the World Bank guidelines, which, together with the analysis of the debt structure by creditors, are presented in the Bank's annual report. The National Bank, assisted by the UNDP, has set up the UNCTAD external debt management software to provide for more accurate recording of the total external debt including the short-term debt and provide tools for more comprehensive debt sustainability analysis. There are needs for training of the department staff both for using the software as well for acquiring analytical skills for the debt management analysis. There is no central record for the total public domestic debt in the country. The amount of the public domestic debt is not significant for the time being since the Government has restrained itself in the previous years from borrowing on the domestic market and has been covering the budget deficit almost exclusively with funds from abroad.

nature of the budget process, de facto depriving central authorities of the ability to impose hard-budget constraints on line ministries; (ii) policy volatility, making it more attractive to try and accommodate ad-hoc demands; (iii) the possibility of having to face off-budget liabilities, thus creating an incentive for building "fat" into the budget; and (iv) the recourse to IMF forecasts in establishing normative revenue targets later in the year.

2.28 Although the use of sophisticated forecasting models (Table 2.5 describes the current approach) can certainly improve the quality of estimates, they will be less helpful as long as process and incentive issues are not addressed. The Government's planned improvements to the 2003 budget process will only be effective if they are accompanied by a realistic macroeconomic forecast. This could be done by clear delineation of roles within the existing structures and formal consultation mechanisms, including with the IMF and the central bank (NBRM). Furthermore, this process needs to be opened to external scrutiny so as to make it more binding and thus improving its reliability. A process that has been shown to work in other countries is shown in Table 2.6.

Table 2.5: Forecasting Approach in FYR Macedonia

	Macroeconomic	**Revenue**	**Expenditure**
Modeling Approach	**Extrapolates**	**Extrapolates**	**Incremental**
Multi-Year	No	No	No
Comprehensive	Yes	No	No
Influences Budget Allocations[48]	No	No	No
Influences Strategic Policy Choices	No	No	No

[48] This refers to the internal forecasts, not the IMF's November forecast.

Table 2.6: A Process for Coordinating Macro and Fiscal Forecasting

Step	Action	Responsibility	Output	Capacity building required
1.	Preparation of a medium-term (3 years) macro-economic framework.	Ministry of Finance	Draft forecast linking macro aggregates with debt and fiscal aggregates	Yes
	Preparation of revenue estimates.	(Revenue Office)	1. Revenue estimates based on macro framework and fiscal policies. 2. Assessment of revenue trends and justification.	Yes
	Forecasting debt service	Central Bank	1. Complete domestic and international debt service forecasts. 2. Debt sustainability analysis	Yes
2	Review debt forecasts and analysis with MoF	Central Bank	Improved forecasts	No
3	Discussion on revenue with Budget Department	Revenue Office	Improved revenue forecasts	No
4	Discussion on macro framework with MoF (Revenue office and Budget Dept) and NBRM	Ministry of Finance	1. Revised forecasts 2. Macroeconomic assessment of forecasts	No
5	Aggregate Budget based on revenue, debt and macro estimates	(Budget Dept)	1. Overall Budget 2. Macro-fiscal assessment	Yes
6	Overall review of macro and fiscal estimates with : NBRM, Ministry of Finance	Ministry of Finance	Adoption of macro and fiscal forecasts for following year	No
7	Consultation with IMF	Ministry of Finance	Improved forecasts	Support by IMF
8	Submission to Government	Ministry of Finance	Adoption by Government	No
9	Publication of forecasts	Government	Binding the Government to the forecast through transparency	No

Articulating Strategic Priorities

2.29 Governments indicate their preferences in a variety of ways. Whatever the mode of expression, a connection must be made between the policies being proposed and the resources available to deliver these promises. Government vehicles that approximate strategic policy priorities in FYR Macedonia are listed below:

- *The First 100* Days, contained the government's legislative and regulatory program through to the end of 1999;
- Individual policy framework strategies; e.g., public administration reform and European integration, the "Program for Development of the Republic of Macedonia (for initiating investments, with Special Review on attracting foreign direct investments)";
- The 3-year public investment plan;
- The 2001 priority-setting exercise (never implemented because of the security crisis); and
- The process used to identify capital projects from telecom privatization proceeds.

2.30 *The First 100 Days* indicated the government's legislative and regulatory intentions through the end of 1999. In theory, but not in practice, it was to be revised for the upcoming year each December. *The First 100* Days did not provide any fiscal assessment of the various initiatives listed in the program, nor was it instrumental as a source of guidance for the budget process. It was presented to Parliament but was not widely available to the public. Accordingly, it did not meet any of the criteria of a strategic document, although it certainly provided a foundation on which a priority-setting process could be built. By contrast, Bulgaria presents its 4-year program to parliament at the beginning of its term of office, publishes it on the internet, presents update reports to parliament each year, and invites public comments on its continuing relevance (see Table 2.7).

2.31 The 2001 priority-setting process would have improved considerably on this effort as it was to be accompanied by the preparation of a fiscal strategy. However, the intrusion of the crisis precluded the completion of a meaningful fiscal strategy and obviously the policy priorities were overtaken by events. The Government has now approved a budget process for 2003 that includes priority setting within a realistic fiscal plan. Such improvements are essential if the implementation the Framework Agreement is to be undertaken within an integrated fiscal and policy framework.

2.32 A number of sectoral policy frameworks (e.g., public administration reform) and the public investment plan have provided multi-year strategic policy frameworks and are publicly accessible. As such, they potentially could have served as priority-setting vehicles for the Government. In practice, however, their lack of influence in the budget process meant that they served only as broad statements of intention or as authorization for drafting legislation. Often, sector policies have not been clear concerning the interrelationship of fiscal and policy objectives (e.g. Education). Table 2.8 underscores the disconnect between the strategic policy and fiscal processes.

Table 2.7: Strategic Priority-setting in FYR Macedonia in 1999

Step	Date	Actor	Action
1	Nov. 98	Prime Minister & Parliament	Within 20 days of appointment by President, PM-designate delivers high level description of government's program to parliament in conjunction with their approval of new government. This does not include a fiscal framework, although broad fiscal policy objectives may be included.
2	Oct./Nov. 98	Ministry of Development (now Finance) & ministries	Call letter issued and ministry submissions provided for Public Investment Plan (PIP).
2	Jan. 99	Government	Ministries provide the government with the list of government commitments for which they are responsible and initiatives they wish to pursue. The government approves the detailed program commitments (primarily legislative) through to the end of the year. Fiscal impacts are not included.
3	March 99	General Secretariat	These commitments are published in the document "The First 100 Days." This document could be obtained by the public, but it is not distributed.
4	Oct. 99	General Secretariat	Requests from each ministry a list of items, including legislation, for inclusion in next year's government program. No limits on volume or content are imposed. Costings are not requested.
5	Jan. 00	Government	Based on ministry proposals, approves the new government program, including its legislative agenda. It was to be published as the successor to "The First 100 Days" to cover the year 2000, but was never concluded. The General Secretariat does continue to track ministry progress in delivering known legislative commitments. No attempt is made to limit the volume of legislation coming forward. Parliament has traditionally been able to handle a high volume of legislation: 683 bills from 1991-94; 371 from 1995-98. Currently, the major impetus for draft legislation is compliance with European Union law.

Table 2.8: Strategic Policies and Fiscal Process

	Influences budget	Identifies costs	multi-year
First 100 Days	No	No	No
Individual Strategies	No	No	Yes
Public Investment Plan	No	Yes	Yes
2001 Priority-Setting Process	Yes*	No	No

* In practice, did not influence budget because of security crisis

2.33 Once governments have established their strategic policy priorities within a fiscal framework, detailed policy choices emerge, through budgeting and legislative programming and within available resources, to maximize the government's strategic directions. **FYR Macedonia's budget and legislative program are developed without any prior direction as to what objectives, either fiscal or policy, they should be trying to achieve (except for IMF programs).** Table 2.9 describes the budget preparation process used for the 2000 budget. Although improvements were planned for the 2002 budget, the security crisis resulted in an inability to conclude a reliable macroeconomic framework. The new measures approved by the Government for the 2003 budget will address many of these problems.

Table 2.9: The Budget Preparation Process in FYR Macedonia -- 2000 Budget

Step	Month	Responsibility	Actions
1	March	Ministry of Development (now part of Finance)	Prepares initial macroeconomic forecast, "a basic short-term (annual) development document." It contains 5 economic indicators (e.g., GDP growth, employment level) and a broad description of some major policies that may affect fiscal planning.
2	Mar./Apr.	Ministry of Development	Finalizes PIP which is approved by Government. Although it represents the government's capital strategy, it plays very little role in the budget process.
3	June/July	Ministry of Development	Updates macroeconomic forecast for incorporation into Ministry of Finance's July document.
4	July	Ministry of Finance	Minister presents report on fiscal situation to Government, containing four main sections: macroeconomic; revenue (projecting forward for remainder of year based on mid-year actuals)[49]; expenditures and external debt.
5	July	Ministry of Finance	Incorporates macroeconomic forecast for following year with highly positive fiscal assumptions[50] in budget circular
6	July	Ministry of Finance	Issues budget circular to ministries, extra-budgetary funds, and municipalities. No instructions are provided on how to interpret macroeconomic figures. Neither an aggregate expenditure limit nor notional ministry allocations are established. Some general guidance is provided on budget objectives.[51] Three years expenditures are requested but only 1 year is used. Six forms are included.[52] There are 6 expenditure categories.[53]
7	Sept.	All ministries	Submit ministry budgets to Finance. These are often submitted late. They routinely and grossly over-request what will ultimately be approved.
8	Sept./Oct.	Ministry of Finance/all ministries	Conduct bilateral negotiations. These meetings tend to last 1-2 hours each over a period of 2 weeks. The focus is on eliminating the numerous requests for new spending initiatives from the ministry's submission. No target is referenced.
9	Oct.	Ministry of Development	Ministry of Development submits final macroeconomic forecast.
10	Nov.	Government	Extended Government meeting to deal with ministry disagreements with Finance. Government decides and adjusts total upwards. Produces expenditure total for discussion with IMF.
11	Nov.	IMF	At the end of the budget process, the IMF's multi-year forecast is used to establish the aggregate expenditure limit.
12	Nov.	Ministry of Development, IMF, Ministry of Finance	Based on IMF forecast, aggregate expenditure limit is established. Government makes downward adjustments and finalizes ministry allocations.
13	Nov./Dec.	Parliament	Reviews in committee in two phases. Makes changes at the margins, as offsets must be found for any expenditure increase.
14	Dec.	Municipal Governments	Submit municipal budgets to Ministry of Finance.

[49] Main revenue sources cited include personal income tax, sales tax, customs/excise, corporation tax, non-tax revenue.

[50] For 2000, GDP growth was estimated at 7 percent, inflation at 5 percent. The 2000 forecast accordingly shows a significant rebound from the effects of the Kosovo crisis which resulted in a revised 1999 estimate of 4 percent GDP growth. Assumptions provided in support of this forecast included a stable environment, active support of the private sector, positive impact of the *Law on Increased* Employment, increased foreign trade, and admission of FYR Macedonia into the WTO. Effects of the VAT law were not factored into the projections. Interestingly, the November IMF forecast for 2000 was a higher-than-anticipated 6 percent GDP growth.

[51] Some of the points in the 1999 circular (for 2000 budget) included: find efficiencies in the goods and services category to improve the capital/current expenditure ratio; include current implications of capital expenditures; estimate special revenues and identify the legal basis for their collection; and provide suggestions to improve budget submissions of local governments (separate process).

[52] The six forms include: (1) staffing requirements, including number of staff by educational level, anticipated retirements, anticipated new hires; (2) salary requirements, using coefficients (by educational level); (3) salary requirements for managers and officials, using coefficients; (4) overview of funding request by expenditure categories; (5, 6) two forms for special revenues and the expenses covered by these—these are not included in the formal budget submission.

[53] Salaries, transfers, goods and services, capital, loans, interest payments.

2.34 **To use the budget as an instrument for policy choices, the government should be provided with: (i) parameters that force trade-offs; (ii) sufficient time for deliberations; (iii) quality analysis and impact assessments; and (iv) real policy and fiscal alternatives.** Although efforts are being made to introduce such a process, a reliable, policy-based, fiscal strategy has yet to be produced. The status of other needed improvements is outlined below:

- The traditional budget cycle in FYR Macedonia was quite abridged with no meaningful activity beginning before July. The revised *Law on Budget (2000)* requires a Spring budget circular which more closely approximates OECD countries.[54]
- In the absence of a fiscal framework that determines an aggregate expenditure limit or preliminary ministry allocations, ministry budget submissions arrive in Finance with grossly inflated requests. The ensuing bilateral negotiations with Finance may eliminate some of the more egregious items, but there is no structured discipline that encourages ministries to pare down the requests in sufficient time for meaningful negotiations to occur. The new budget methodology will, if applied successfully, address this issue.
- The Government has encountered great difficulty in finding better, more efficient ways of delivering existing services or deciding that some services are no longer required or can be provided by the private sector. The development of an evaluative capacity for reviewing core and non-core functions and proposing divestments is at a very early stage in FYR Macedonia.[55] However, the Government has made recent progress in this area with its approval of a first generation of divestments (e.g., Court Evidence Bureau, select educational institutions, select functions in the General and Common Services Bureau). A plan for a second round of divestments will be reviewed by Government in 2002 (see Chapter 1).
- The legislative cycle occurs following rather than in tandem with the budget process. The circular requesting proposed legislation is distributed to ministries just as the Government is finalizing ministry budget allocations. The government's legislative program is not even reviewed until Parliament has approved the annual state budget. There is no public dimension to the process.[56]
- The government's legislative program is established without applying limits on the volume of legislation or considering the impact of parliament's cumulative workload.[57] It also does not require that fiscal impacts or policy impacts be identified

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[54] In Sweden, the process begins in January so that a Fiscal Policy Bill outlining key economic and fiscal indicators, the overall expenditure limit and indicative funding levels for 27 expenditure areas can be introduced in Parliament by April 15. France begins its process in January so that by March "lettres de cadrage" can be forwarded to each ministry outlining the macroeconomic framework and budget objectives.[54] Budget conferences on ministry appropriations begin by May.

[55] In Britain, for example, fundamental expenditure reviews have produced billions of pounds in savings in sectors such as defence, social security, legal aid, national health service and education funding. In other countries, program reviews, business planning, alternative service delivery, performance measurement, and pay for performance systems are just some of the tools used to evaluate and improve service delivery. However, such techniques cannot be introduced in developing countries without ensuring that the basic systems required to support them are in place.

[56] In Westminster systems (e.g., United Kingdom, Canada, New Zealand), the government's legislative program for the coming session is set out in the speech from the throne. In Bulgaria, the government's legislative program is published on the internet.

[57] Although Parliament has shown a remarkable capacity to deal with large volumes of legislation, there are presumably upper limits to its ability to process legislation in a way that permits meaningful review. 683 laws were passed from 1991-94; 371 from 1994-98, an average of 132. By comparison, Bulgaria passes 56 laws per year.

prior to the draft legislation being presented to the Government.[58] Thus, there are few political or fiscal incentives for limiting the volume of prospective legislation at the budget planning stage.

- Given the tendency to resolve the fiscal framework late in the process (in the past, with the November IMF forecast; or not at all in 2001), the gap between the desired and available resources can be significant[59]. At this point, the real trade-offs are completed, but obviously not on a policy basis grounded in considered analysis. Such problems were evident during 2001 where the security crisis resulted in relatively unchecked, crisis-related hiring in the Ministries of Defense and Interior.
- The PIP is disregarded during budget planning[60] as the approved capital expenditures do not directly reference the priorities or projects identified in the PIP, nor does the PIP reflect any deliberations on how it might support any strategic or sectoral priorities. Essentially, the PIP exists as a capital strategy that is de-linked from strategic priorities and devoid of fiscal relevance. In 2001, capital planning was dramatically affected by the availability of US$125 million of the proceeds from the telecom privatization for investment projects, to be spread over three phases. US$96 million was allocated to the first two phases using a rudimentary priority-setting process, designed with World Bank assistance, that took into account the relative cost/benefits of a large volume of proposals. An evaluation of the first two phases is to occur before proceeding with phase three (US$29 million). However, the security crisis has affected the initial stages of this plan as approximately US$57 million of the telecom proceeds was allocated to security-related expenditures.

2.35 From the government's perspective, the budget process remains highly dysfunctional. Ministers are forced to take decisions within a very limited time frame based on sketchy information and without full knowledge of alternatives or consequences.[61] Moreover, the assumed level of available resources is subject to last-minute revision, usually downwards, thereby forcing an even more abridged final decision-making round. Crises in 1999 and 2001 have further added to this lack of certainty.

[58] Lower priority legislation is often prepared by program staff without any legal training. Moreover, rushed deadlines limit the quality of review by the General Secretariat. The strong focus on legal compliance and compatibility with European law is not supplemented with any policy or political assessment. In countries such as the United Kingdom, Canada, and New Zealand, extensive standard information requirements are set out in cabinet submission guidelines. These compel ministries to provide in advance of cabinet consideration a detailed policy rationale, business case, project appraisal (for capital initiatives), multi-year resource requirement including impacts on other ministries, economic evaluation, social impact assessment, alternative approaches, and communications strategy.

[59] Based on a questionnaire (1999), the budget had to be revised by up to 125 percent.

[60] For example, in 1999, the PIP proposed a ceiling of 19,602 million denars, of which 3,326 million denars was to be derived from the state budget. The actual 1999 budget contained 2,549 million denars (increasing to 3,211 million denars if special revenue expenditures are added) for capital transfers and acquisitions.

[61] Typically, the amount of information and quality of analysis concerning individual initiatives increases at each stage of the process. At the priority-setting stage, information and analysis may be very general. By the time ministry budgets are finalized, the initiative should be well-defined with a clear sense of options, impacts, and financial requirements. Further details and refinements will become available as the actual draft law or program design is completed. However, for any major initiative, ministers require a solid assessment of policy options, impacts, and multi-year financial requirements before allocating resources in the budget.

Multi-Year Budgeting

2.36 **In terms of planning horizon, two problems arise: (1) the annual budget has a one year focus; and (2) multi-year policy strategies are not budgeted.** Even with improvements in the *Law on Budget*, the practice remains single year. Although the budget circular actually requests expenditure projections for three years, it is acknowledged that little of the out-year information is used. In a true multi-year process, expenditure estimates would account for annualized staffing costs, implementation phases (especially capital), and programs where costs are affected by demographic or economic variables. In FYR Macedonia, this level of information is not provided.

2.37 **Single-year budgeting is inherently problematic both for policy reliability and fiscal stability**. Laws may be passed and start-up funding provided, but the program manager has no indication, let alone guarantee that sufficient funds will be available in future years. For new entitlement programs, the potential exists to incur future liabilities that may severely restrict funding available to other programs. This problem is intensified when governments make policy commitments, thereby creating political pressure for funding, without a multi-year perspective on financial requirements. The fiscal uncertainty resulting from the crisis has intensified this problem. In the long run, frustration will arise within Government as assumed accomplishments in reality continue to yield few tangible results.

Budget Unpredictability

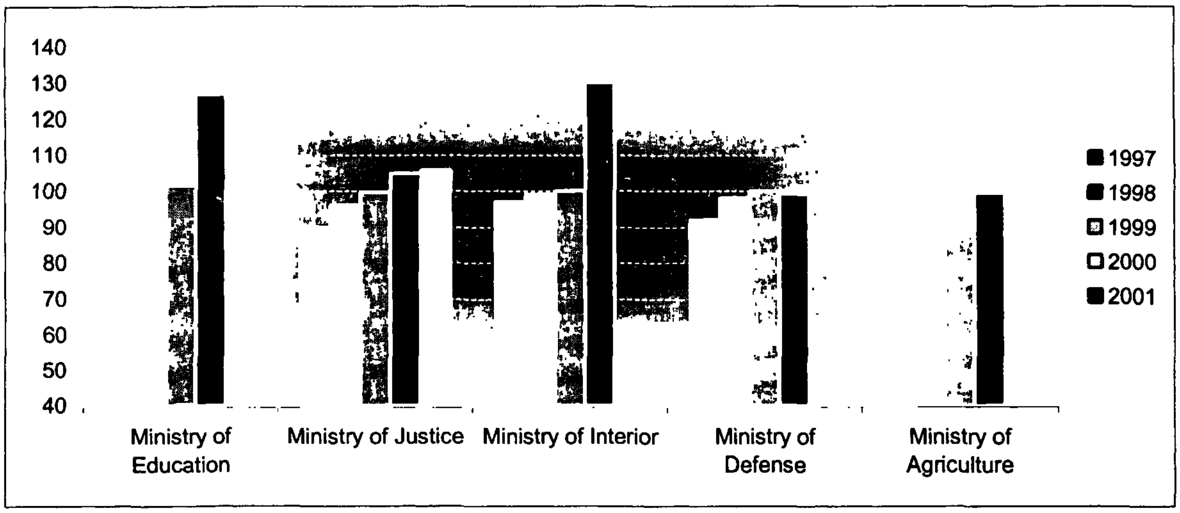
2.38 The budget represents the fundamental vehicle for articulating and delivering government policy. Typically, where budgets are not reliably implemented, policy inconsistency will follow. Further illustration of this problem is provided when one examines the relative levels of deviation between approved budgets and actual allocations:

- Such deviations tend to highlight the problem that the budget formulation process is routinely generating over-committed budgets that cannot in practice be implemented. The pattern of deviation can give some guidance on where this problem is most acute;
- If expenditure managers perceive the formal budget as of limited relevance for actual resource allocations, this will depress incentives to commit to improved budget formulation, such as the budget strategy recommended below; and
- If resources are not provided in line with the approved budget, the basis for holding agencies accountable for performance is undermined, as discussed further in the next chapter.

2.39 As shown in Figure 2.1, **predictability of resources to line ministries is uneven**. A key point is that not all ministries are equally penalized by revenue shortfalls (1997-1998) or rewarded in case of revenue windfalls (1999 and 2000). This tends to show that reallocations are ongoing during the budget year based on the economic classification proportions of each ministry's budget; i.e., since wages are paid as a priority, ministries with a higher wage bill as a share of their budget (e.g. education) tend to secure resources whereas others with, say, a higher capital investment or transfer share (e.g., Ministry of Agriculture) stand to lose relatively more. Other factors explaining the relative volatility of resources across ministries are the relative power of ministries and discretion in the use of cash.

2.40 The discussion has underscored how budget unpredictability reinforces the problems with policy reliability. Rather than Government decisions being guided by a strong policy framework and set of priorities, policy volatility is induced by short-term fiscal imperatives with respect to compressing key expenditures. The resulting imbalances in budget composition have contributed to lower productivity of the administration and efficiency of the budget (for example: poor maintenance in school buildings). In Chapter 4, it will also be shown that human resource management does not provide adequate incentives for performance. The new budget process approved by the Government for the 2003 budget will, if implemented successfully, begin to address the problems of budget predictability and excessive policy volatility. The discussion below provides a framework within which budget reform should be undertaken in the medium term.

Figure 2.1: ***Actual as percentage of original budget***[62]



Reforming the Budget Process

2.41 The challenge in the design of policy-making and public expenditure management institutions in any country is to establish mechanisms and rules that facilitate and encourage, rather than militate against striking a reasonable balance between short-term and longer-term policy objectives. **The majority of these recommended budget reform elements have been adopted by the Government of FYR Macedonia for the 2003 budget process.**

2.42 The very early stage of budget reform suggests that any reform strategy will have to focus on process basics and capacity building. **As reform proceeds, its success will become increasingly dependent on how well it links with related reforms such as government restructuring, central agency reform, functional reviews, public administration reform, internal audit, performance evaluation, and anti-corruption measures.**

2.43 The key elements of an improved budget process (See Table 2.10) include:

- earlier start to budget cycle (now legislated);

[62] Data for 2000 are unavailable for comparison, given government restructuring.

- multi-year budgeting (legislated, but not practiced);
- establish aggregate expenditure and revenue targets at the outset of the budget process based on improved forecasts;
- priority-setting phase, where preliminary aggregate and ministry expenditure allocations are established; (this was attempted unsuccessfully for the 2002 budget);
- better integration of Public Investment Plan with the budget process; use the Public Investment Plan as the primary source for identifying capital requests during preparation of ministry budget submissions;
- provide instructions in the budget circular indicating how to relate capital and current expenditure requests and how to prepare meaningful expenditure estimates for the 3-year time frame;
- more time for analysis and negotiations by the Ministry of Finance;
- more time for government decision-making; and
- increased and earlier involvement by Parliament.

Table 2.10: Recommendations for an Improved Budget Preparation Process

Month	Action
February	▪ The MOF produces reconciliation report between previous year's forecasts/budgets and actual performance[63] ▪ The General Secretariat produces report on policy/legislative/program results vs. commitments from previous budget year
March	▪ MoF coordinates with NBRM to prepare the macro-fiscal framework ▪ General Secretariat prepares presentation for government on progress to date, program for current year, and priority options for next year (and, at a more general level, for the following two years)[64]
April	▪ The MoF prepares a fiscal policy statement formalizing Government's fiscal stance through a medium-term fiscal policy statement ▪ The MOF presents Government with multi-year priority options ▪ Government makes preliminary decisions on key fiscal issues [deficit target, tax measures, aggregate expenditure limit, overall new initiatives funding, expenditure reduction target, salary levels, capital and current budget levels, levels for key transfers] ▪ Government makes preliminary decisions on policy/legislative/capital priorities [accompanied by estimates of financial requirements, policy impacts, and project appraisals] ▪ Key elements of fiscal plan reviewed with IMF
May	▪ based on fiscal framework and priority decisions, Government establishes preliminary ministry allocations ▪ General Secretariat prepares document summarizing overall plan for presentation to parliament ▪ MOF issues budget circular outlining economic and fiscal forecast, policy and expenditure reduction priorities, preliminary ministry allocations, legislative requirements
June	▪ Ministries prepare detailed budgets, including (i) integrating investment and recurrent budgets and showing explicitly the recurrent cost impacts of investments; (ii) legislative requirements[65]
July	▪ Budget submissions by line ministries: new proposals submitted separately, all new proposals show (i) expected achievements in terms of outputs/outcomes (ii) costs of proposals ▪ Costs are signed off by the Ministry of Finance. ▪ Line ministries submit detailed budgets to Ministry of Finance
August	▪ MOF presents updated macroeconomic, revenue and expenditure forecast to government; impact on budget assessed ▪ MOF analyses budget submissions; prepares negotiating strategy
September	▪ Bilateral negotiations with ministries
October	▪ Government reviews ministry budgets; addresses unresolved issues
November	▪ Updated macroeconomic, revenue and expenditure forecasts presented to government; impact on budget assessed; IMF consulted ▪ Assess legislative capacity in parliament to determine if backlogs present a problem ▪ Ministry budgets and legislative program revised if required ▪ Government finalizes draft budget law and legislative program ▪ Government introduces draft budget legislation, presents legislative program in parliament
December	▪ Parliament debates budget law ▪ Parliament approves budget law
January	▪ All documents presented with the budget are published

2.44 Rather than proceed as a year-end exercise, the legislative program should be developed in tandem with priority-setting and the budget process. Basic steps would include:

[63] Real progress on reporting can only be made once the accounts are made more transparent. See section on reporting. The annual Budget report is published in the Official Gazette of the Republic of Macedonia. The Report is a detailed listing of amounts showing actual spending for the past year, along with the budget for the current year and the estimated budget for the subsequent year. The report does not compare actual spending for the year to the budget for that year, nor does it provide any analytical information to help readers understand how or why the money was spent, and what results were achieved. While the report is factual, it is not very informative or in a format that is user-friendly.

[64] In some systems, a formal request would be made to ministries to provide information on key priorities at this stage to assist with this presentation. In other systems, sufficient information is available at the center, or derived from an approved multi-year government program, to prepare this without any formal ministry involvement at this early stage.

[65] As the information base and budget preparation requirements become more sophisticated, this stage may become a two-step process: first, key policy decisions and expenditure levels are finalized at the program or key function level; second, detailed budgets are completed.

- assessing both fiscal and legislative impacts of the government's strategic priorities; this provides a start point for the budget and the legislative program;
- including in the budget circular (or in a parallel circular from the General Secretariat) a requirement to identify all legislative as well as fiscal requirements for next year;
- requiring estimated funding requirements for any proposed legislation;
- prior to finalizing the budget, assess whether the current legislative backlog in parliament, combined with the proposed volume of new legislation, will affect the implementation time frames, and therefore the funding roll-out, of any ministry initiatives;
- approve the legislative program at the same time as the draft budget; and
- require that multi-year fiscal impact statements accompany any policy strategy or law proceeding for Government approval based on codified standards (approved, but not fully implemented).

2.45 Progressively, the cycle would evolve as described in Table 2.10 which shows a sequence of events that permits some fundamental budget objectives to be achieved. Nothing is accomplished, however, unless the necessary improvements in staff capacity, quality of analysis, and information bases are implemented as part of the reform. Successful budget systems are those where resource allocation is a subset of policy and program decisions that are based on a clear fiscal plan and defined performance expectations within a transparent process. Measures to ensure and strengthen accountability to Parliament and the public need to be established from the outset of the reform process. Some of these improvements are reflected in the new *Law on Budget* and the Rules of Procedure. As policy and budget reform proceeds further, it should support the philosophy set out in the public administration reform strategy where reforms such as restructuring and the creation of a professional public service are better integrated.

BUDGET FRAGMENTATION

2.46 The budget covers just over 50 percent of public resources (see Table 2.11). Issues of particular relevance will be analyzed here: (i) special revenue; (ii) explicit guarantees; (iii) implicit liabilities; (iv) donor funding. Financial management of the Health Insurance Fund is analyzed in Chapter 3.

Table 2.11: Budget Coverage (1)

	Budget	**Special Revenue/ expenditure**	**Off-budget Funds**	**Donor-financing**	**Explicit Guarantees**	**Implicit liabilities (2)**
Budget	Yes	No	No	Partly (3)	No	No
As % total expenditure	51%	10%	30%	9%	N.A	N.A.

(1) Estimates for 1999. Data for 2000 are not available for special revenue. Due to the Kosovo crisis, donor financing was much higher than in 1998. Since explicit and implicit guarantees and have not been estimated, the calculation excludes them.
(2) These refer to the Government's interventions in the financial and public enterprise sector discussed in Chapter 1.

Special Revenue

2.47 Until 2001, the budget excluded transactions on special revenues generated by individual budget units and expenditures financed by those revenues. Special revenues have traditionally been regarded as "own revenues" and under the control of the relevant budget units. Both the *Law on Budget* and the *Law on Execution of the Budget* referred to income earned by 'activities that have not been financed from the Budget'. The revised *Law on Budget* (2000) incorporated the special revenue into the budget starting in 2001. With the assistance of the IMF, the Ministry of Finance has succeeded in recording all revenue and expenditure from special activities based on the budget classification. Incorporation of the special revenue meant specifically[66] :

- The omnibus giro account group # 788 of the budget users harboring extra-budgetary resources has been split into separate giro accounts for more transparent exhibition of the sources of these resources: # 787 for revenues from self-financed activities like running training centers, transportation fees, and other functions not directly arising from the normal operations of the agency; # 631 for self-collected revenues which arise from normal functions of the agency like passport fees, license fees, court fees et al; # 785 for grants (in Denars) received from domestic and international organizations for specific projects of the agency for which the donors require separate accounts to be maintained; and # 786 for loans (in Denars) received from international agencies for earmarked projects.[67] The bank accounts corresponding to these giro accounts have merged with the TSA on 1-1-2002 and the corresponding giro accounts are now in the treasury ledger.
- Starting in 2001, the government budget distinctly exhibits in four columns the source of funding of budgetary and extra-budgetary expenditures against each line item of the budget. This reform has enhanced the transparency and accountability of budget users and has brought the extra-budgetary operations under the treasury oversight.
- With the annual budget disclosing the source of finance, the treasury expenditure authorization procedures (discussed in detail in Chapter 3) apply uniformly to both budgetary and extra-budgetary expenditures. Each line ministry/spending unit is required to indicate the source of funding desired in its expenditure requests; the treasury approvals and expenditures are recorded distinctly against the relevant source

2.48 While substantive progress has been made on integrating special revenue into the budget, a number of issues remain with respect to revenue related to fees, tuitions, commercial activities, etc.:

- Although they are now in the budget, they remain earmarked to specific uses, thus restricting the capacity of the Government to make funding tradeoffs within the budget formulation process. If added to the pool of revenue available to the

[66] From P. Desai (IMF), 2001.

[67] With the opening of giro /ledger accounts # 631, 785, 786, and 787, the omnibus account # 788 has become defunct except, inexplicably, in the case of universities which continue to club various types of extra-budgetary receipts into the omnibus account # 788, thereby clouding the transparency of source of funds.

government, this significant component of the budget could be assigned to priority areas rather retained by the collecting budget unit.

- Not enough is known about the overall policy impact on areas such as small business or education affordability. Although conjecture, it would not be surprising to find that budget units increased special revenues during periods of economic and fiscal crisis in order to alleviate their immediate cash rationing problems. Doing this, however, would intensify the negative fiscal impact on those such as small businesses obliged to pay the fees at the worst possible time in the business cycle.
- 35 percent of expenditures financed under special revenue went to wages in 1999. It can further be assumed that these revenues were used for either supplementing salaries or recruiting staff, which played havoc with the Government's attempt to secure a wage and employment policy. This created incentives for public employees to tax the consumer, as well as creating recurrent charges that were difficult and costly to reverse under the current laws.

2.49 Measures which would address the problems of special revenues include:

- **Eliminate or move special revenues that are not clearly user fees into the budget (2003).** While all special revenue should be incorporated into the budget, it does not mean they all should be competing with other resources. There is a wide spectrum of possibilities (from full retention to any degree of sharing with the budget) depending on the nature of the function performed with special revenue. For user fees, means of preventing cross-subsidization of those activities should be considered. Barring this, such revenues could be folded into the budget. An initial step toward this would involve undertaking analyses of entities within each of the three Ministries that generate the largest special revenues (Ministry of Education, Ministry of Defense, Ministry of Interior) to see which entities could be formally taken entirely off budget (i.e., precluded from accessing budgetary funds).
- **Deal with balances in a transparent way and secure incentives for line ministries to collect special revenue.** The *Law on Budget* could be revised to spell out more specifically what first and second line users are entitled to do with balances arising from special revenue. Currently, the law on the execution of the budget states only that the revenue arising from these activities needs to be deposited in a the Treasury Single Account. No reference is made to balances. Based on other countries' examples, various possibilities exist. For example, end-of-year positive balances in special revenue accounts (arising when expenditures are lower than revenues within the budgeted amounts) should be returned to the budget. Positive balances arising when revenue performance is beyond the budgeted amounts can be retained and used during the following year towards expenditure agreed during the previous year. The latter mechanism provides an incentive for special users to continue collecting special revenue.
- **Regulate the use of special revenue.** Special resources can be used for purchasing assets, and the budget users are then free to dispose of these assets. This provides an incentive to use special revenue towards commercial (profit-making) activities, and should be regulated.

Guarantees

2.50 Guarantees can be explicitly or implicitly provided by Governments.[68] In FYR Macedonia, for the first time in 1999, a partial accounting of Government's explicit guarantees has been reported to the IMF. In 2000-2001, the Government made significant strides to improve the management of guarantees:

- Domestic guarantees have been recorded centrally at the Ministry of Finance through the creation of a registry. A link with the National Bank's registry of foreign currency guarantees may be established in 2002.
- With the revision of the *Law on Budget* (2000), guarantees to public enterprises are subject to the Ministry of Finance's and Parliament's approval and guarantees to the private sector are forbidden;
- The Government has decided to adhere to agreed ceilings and include guarantees with the budget documentation to Parliament starting in 2002; a statement on guarantees will also be part of the previous year's final accounts.

2.51 Remaining recommendations (see summary in Table 2.10) to improve management of guarantees to public entities include:

- **The Government should ensure that the registry of guarantees is comprehensive.** Some guarantees previously given by line ministries may not be recorded, and pose a risk. Furthermore, as was done in Estonia, the Government should consider adopting a regulation making explicit that it shall not assume responsibility for previous guarantees provided by line ministries without prior approval by the Ministry of Finance.
- **Transparency and risk management of guarantees to public sector entities need to improve to safeguard against further risks.** To that effect, the Government could go further and incorporate guarantees into the budget (on a cash basis). In that case, budget controls for guarantees should be made explicit and the guarantees should compete with other claims. The Government could adopt the steps taken by the Government of Hungary: (i) the volume of guarantees authorized in the budget is limited to a certain percentage of State revenues; (ii) the budget sets aside funds for payments expected to be made during the fiscal year pursuant to existing guarantees; (iii) material information on new guarantees (such as the amount, conditions, justification, lender and borrower) are published in a Government resolution; (vi) the annual budget reports the probability of default and expected payments for each guarantee program; (vii) the issuance of guarantees is effectively reported to the State Audit

[68] Explicit guarantees (e.g., guarantees provided by Governments to public enterprises, local governments and the private sector) are recognized in a legally-binding document such as a loan covenant or an insurance policy, and the extent to which government makes payment hinges on uncertain future occurrences, such a default or insolvency. Although these liabilities are explicit, budgeting for them is difficult because no payment is made at the time the obligation is incurred, and the amount and timing of future payments may be highly uncertain. Adapted from A. Schick: "Budgeting for Fiscal Risks".

Office, and audited (in FYR Macedonia, State Audit's responsibilities already cover State guarantees).

Table 2.12: Approaches to Management of Guarantees[69]

Approach	Main Objective	Limitation(s)/risks
Comprehensive registry and disown previous guarantees given without MOF's approval	Transparency: fuller account of financial condition and risks	The Government may not have accurate, comprehensive financial statements; just recording guarantees and passing regulation may not itself disengage Government responsibility.
Cost-Based Budgeting	Budget allocations reflect prospective cost to government; risk taking competes with other claims on budget	Costing methodology not well-developed, and cost estimates may be unreliable. May be treated as technical exercise rather than as real allocation of resources.

Implicit Liabilities in the Banking and Public Enterprise Sector

2.52 Two characteristics of these liabilities undermine fiscal discipline. One is that the bigger the loss, the greater the probability that government will accept liability. Second, to the extent government intervention is expected, moral hazard increases. While two schools of thoughts exist on whether budgeting for implicit liabilities is desirable (supposing it were possible), there is serious concern in FYR Macedonia that budgeting for them would in fact increase moral hazard. However, given the risks on fiscal sustainability, the Government should envisage the following options:

- **Ascertain the extent of the loss-making enterprises and banks' liabilities** (referred to in Chapter 1).
- **Set up at the Ministry of Finance a coordination unit for analyzing and reviewing data provided by the PA and the BRA.** This unit should be prepared to devise options for privatization and liquidation of loss-making enterprises and banks, and report confidentially to the Government. However, a critical assignment to the unit would be to compare the costs of different options, and propose a limit to the costs the Government should be willing to incur. In some countries these caps have been established at certain percentages of revenue.
- **This unit should inform the budget.** Provision (devised as lump sum) in the budget for the cost of restructuring the loss-making enterprises and banks should be made. This provision should be made explicit and stand in competition with other claimants for public resources.

[69] Adapted from A. Schick. *Op cit.*

Donor Funding

2.53 There seems to be no regulation or clearly defined process for including donor funds in the budget, although it is partially reflected. The MOF does not have the capacity to properly record all the revenues on a grant basis and to track the expenditures financed from those funds as grant revenues.

2.54 For the 2003 budget, it is recommended that:

- **The *Law on Budget* be amended to allow for the inclusion of all project-linked foreign financing in the PIP.** These projects should appear in the line ministries' budget submissions, coded for source of financing, type of assistance, project number and disbursement schedule. Counterpart funding from the Government should also be identified. Disbursements of foreign financing under projects should be reported by line ministries to the MoF on a regular basis (at least quarterly).
- **All grants and loans for general budget support should also be included in the budget.** Monitoring of grant funds could be made possible by setting up separate accounts for grant revenues — so as to separate them from the rest of the budget user's revenues.

3. BUDGET IMPLEMENTATION, MONITORING, AND ACCOUNTABILITY

INTRODUCTION

3.1 Excellence in policy formulation will have little impact on policy quality if severe weaknesses arise during implementation. In this chapter, budget implementation in both the central government and health insurance fund will be assessed by examining whether the necessary financial management and control systems are in place. In addition, the adequacy of monitoring and accountability (internal and external) systems will be reviewed.

ACCOUNTING, FINANCIAL MANAGEMENT AND CONTROL : CENTRAL GOVERNMENT

Overview

3.2 The 1993 *Law on Budgets* (effective January 1994) and the *1998 Law on Budget Execution* established the basic parameters for financial management and control. These were supplemented by the *Decree on the Plan of Accounts* and the *Balance Sheet of the Budget of the Republic of Macedonia, Budgets of the Units of the Local Government*, and *Budgets of Funds*. The Minister of Finance is responsible for prescribing the standards and record-keeping. The *Law on Budgets* has wide application to the central government, municipalities (self-government units), and the four extra-budgetary funds: Pension and Invalids Insurance; Health Insurance; Republican Fund for Employment; and Road Fund.

3.3 The Ministry of Finance allocates the budget to 1st line budget units, which in turn make allocations to 2nd line budget units. There are 126 1st line units and 1,164 2nd line units, although the number of units changes from year to year. A ministry may be divided into a number of 1st line units. The Ministry of Education, for example, is divided into four 1st line units. More than half of the 1st line budget units constitute elements of the justice system, including 65 individual courts, legal offices, prisons, and prosecutor's offices. Four ministries are responsible for the bulk of the 2nd line budget units. Allocations are divided into economic, functional and organizational categories.

3.4 From 1999-2001, with IMF assistance, the Government established and operationalized the Treasury --see Annex 3.1 for details and Box 1 for a description of its predecessor, ZPP. The following functions are now operational:

- The Treasury single account (fully operational by 2002);
- Comprehensive coverage of all budget institution accounts;
- Integrity of revenues and expenditures (separation of budget activities, self-financing, grants, credit program);

- Control of budget execution;
- Approval of payments;
- Control of cash and elimination of idle cash balances;
- Cash management (revenue and expenditure forecasting);
- Initiation of the debt management function by implementation of a register of guarantees;
- Development of budget execution procedures, accounting methodology and general ledger; and
- Management reports.

Box 3.1. *ZPP (Zavod za Platen Promet)*

The ZPP was the Payment Operational Service in the Republic of Macedonia. It operated about 100,000 separate giro accounts, of which 60,000 are active. Through head office and thirty-two regional offices, it handled from 60,000 to 80,000 transactions per day. When tax payments are due on the 5th and 15th of the month, the number of transactions on those days could reach 120,000. All government and private sector entities were registered and had accounts with the ZPP. Revenue deposits and payment orders were processed in the morning and account balances were available by 4:00 p.m. each afternoon. The ZPP acted as a clearinghouse for all transactions except those involving foreign exchange. The ZPP has a long history of operations, having developed from the 'social accounting organization' of the former Yugoslavia.

It could operate as a preventative control for the public sector, in that the ZPP knew the number of employees and their wage levels (based on the Law on Salaries), so under that system, it was unlikely that unauthorized persons could be paid. No organization could spend more than it had in its account. Also, transfers of funds from one account to another were not permitted. Because organizations were required to submit reports to the ZPP in order to effect financial transactions, it was a very effective central information repository.

Reforms of the ZPP led to the *Law on the Transformation of the ZPP* (2001). Under the law, the ZPP ceased to exist as of December 31, 2001. A clearinghouse for the banks has been created to supersede the ZPP functions, Treasury has developed to take over ZPP payment functions, and the PRO has prepared an action plan for its assuming the collection and management of contributions previously collected (withholding system) by ZPP. The dismantlement of ZPP aims at increasing government's role in public financial management (e.g., revenue collection), while simultaneously developing the banking system. The latter is a component of the Bank-supported FESAL.

While the dismantlement of ZPP should be beneficial in the long-term, concerns have been expressed that a hasty dismantlement would create risks, notably collection, enforcement and management of taxes and contributions, and loss of transparency in the payment system due to the under-developed banking system. Experience in other FRY republics show that hasty measures can result in serious weakening of financial transactions-linked information as well a loss of financial control.

3.5 A few line ministries have their own Accounting and Finance sections, but the majority do not. These functions are provided centrally through the Agency for Common Services, which is financed through the Central Budget. The 123 municipalities do not operate their own Accounting and Finance sections, as these functions are provided by the 35 regional offices of the Ministry of Finance. Here, emphasis is placed on financial reporting rather management information.

3.6 **The accounting system is essentially a cash recording system.** It lacks the discipline and accountability potential of a double-entry accounting system. The budget accounting system now installed at the Treasury simply records, following a single entry recording process, the cash receipts and payments arising from the operations passing through the Treasury. These transaction records are consolidated to generate budget execution reports in real-time, enabling management of government payments by Treasury. Fiscal operations outside treasury administration, including foreign currency transactions and those conducted by extra-budgetary funds, are not consolidated in these accounts. The Treasury does not generate comprehensive annual accounts of government fiscal operations conforming to international government accounting standards.

3.7 **Commitments are not recorded centrally**, permitting the creation of arrears (understood as the difference between commitments and cash). While central government arrears are partially reported, including arrears of the Health Insurance Fund, those of social entitlements (pensions, unemployment benefits, child allowances, social assistance and other allowances) are officially unrecorded.

3.8 Over the next three years, the Treasury aims to establish an integrated government financial management information system, with regional treasury offices, that will begin to register commitments, raise accounting standards to international standards, and incorporate earmarked budget revenues into the budget. **The Government has established a good track record to date in implementing the Treasury.**

3.9 Since the abolishment of ZPP, financial control has been operated through the Treasury -- Table 3.1 sets out the process steps by which funds now flow to budget units. With the existing system it is possible to track transfers from Ministry of Finance to 1st line and to 2nd line budget units and from all budget units to external legal entities or individuals. The transfers from Ministry of Finance to 1st line budget holders are made 3 times per month. The first transfer is to cover salary payments and is based on budgeted monthly salaries and is always paid in full. The second payment, to cover goods and services, and the third, to cover transfers, are also based upon the approved budget. Arrears can occur at two different stages: (i) a spending ministry can enter a legally-binding commitment with a supplier, but the MOF will not be made aware of the commitment if the goods and services are not delivered or the request for liquidating the invoices is not received; or (ii) the invoice is received by the MOF but the availability of cash does not allow for payment. These arrears are recorded at the MOF.

3.10 The expenditure authorization and approval procedures at Treasury ensure that the actual expenditures are booked at the final stage of payment to suppliers of goods and services. While this is a notable improvement over the previous system, the system falls short of recognizing expenditure operations at the pre-payment stage of commitment, and therefore fails to control expenditure arrears. Critical features of budget control that are still absent include: (i) weak commitment control and central recording of arrears; and (ii) inadequate central management of the wage bill (although the MoF has made significant effort towards developing a centrally controlled wage bill database).

Table 3.1: Financial Control on Central Government Budget Execution

Step	Actor	Action
1	Parliament	Reviews and approves state budget
2	MOF	Approves allocations to spending ministries[70]
3	Treasury	On a monthly basis, approves the expenditure plans of first line budget units based on cash flow situation
4	Spending ministry	For salaries, request Treasury to transfer payments to individual employee accounts
5	Spending ministry	For goods and services, allocate funds to permit sub-units to order goods and services
6	Providers	Goods and services delivered, invoices submitted
7	Spending ministry	Request approval from Finance to liquidate these obligations through transfer of funds to their accounts so that they can arrange for invoice payment
8	Treasury	Examines available cash balances and will approve some or all of the requests based on cash availability
9	Treasury	If approved, Treasury transfers funds from the treasury account to the spending ministry account
10	Spending ministry	Requests transfer of funds to the accounts of subordinate budget units and to the accounts of the providers of goods and services.[71]
11	Subordinate budget unit	Requests transfer of funds to the accounts of the providers of goods and services.[72]

Commitment Control and Arrears

3.11 As discussed in Chapter 1, from 1997-2000, spending beyond the budget on a cash basis has rarely been problematic.[73] From a cash perspective, the financial system has adapted relatively well to revenue shortfalls (including shortfalls in foreign financing). In both 1997 and 1998, lower than anticipated revenues prompted the Ministry of Finance to resort to cash rationing. In 1997, cash rationing proved insufficient to control the deficit; in 1998, it was successfully applied to repay arrears. In 1999 and 2000[74], much higher than anticipated revenues outweighed increases in expenditure – see Table 3.2.

Table 3.2: Adjustments to Revenue Shortfalls (Central Government)

In million denars	1997	1998	1999	2000
Revenue shortfall/windfall	-3,018	-1,060	6,681	10,844
Expenditure Adjustment	-523	-2,127	3,882	4346
Deficit/surplus adjustment (1)	-2,529	1,111	2,799	6498

(1) discrepancy in 1997 (34 million denars) and 1998 (-44 millions denars).
Source : Government, IMF, World Bank.

3.12 Since commitments are not reported systematically to the Ministry of Finance, it is difficult to ascertain their exact level. Based on IMF data for general government, the stock of arrears has decreased since 1998 and was entirely repaid in 1999 (equivalent to 0.7 percent of general government expenditure). In 2001, arrears increased again to reach about 0.5 percent of

[70] Technically, this approval relates to all first line budget units, but would be coordinated at the ministry level where there is more than one unit.
[71] The cash backing these balances is lodged with the National Bank of the Republic of Macedonia which pays interest (currently 8.9 percent p.a.) on them to MOF. The cash only leaves the system when there are payments to outside third parties, not when there are transfers within the system.
[72] Steps 5 to 10 are carried out each month and steps 6 to 10 are repeated for each payment request.
[73] Although for 1997, large discrepancies exist between the GoM and IMF tables. Based on IMF tables, cash rationing was inefficient and led to a net increase in the level of arrears.
[74] In 2000, this is due to privatization proceeds to the tune of 10 percent of GDP.

GDP. However, these numbers have to be treated with caution since this does not preclude large amounts of unreported arrears, as the 1999 experience illustrated.

3.13 Anecdotal evidence indicates that the budget constraint is taken seriously for goods and services. In the Ministry of Education, for example, although there are hundreds of budget units, the individual units in the primary and secondary sectors are not allowed to incur any commitments on goods & services without first obtaining approval from the appropriate under-secretary in the Ministry. The record of commitments is maintained in the ministry and a regular report is produced showing for each expenditure line the approved budget, commitments, expenditures, and balance. A sample report was produced for primary education (1999 and 2000) for 47 different economic classifications. This evidence attests that, at least for some ministries, for specific expenditure items, the overall budget limit is not exceeded.

3.14 Essentially, the adjustment of line ministries to revenue shortfalls is imperfect and, while they can certainly respect budget ceilings, they generate arrears as revenue shortfalls occur. This points to the need for better predictability of resources and cash flow management. In addition, since inter-sectoral re-allocations (during budget execution) appear relatively significant, some ministries are more likely to incur arrears as their resources are being diverted elsewhere. To support this assumption, it can be shown that the variation in the level of arrears is smaller than the revenue shortfall: in 1997, arrears increased by 55 million denars while the revenue shortfall was 2.8 billion denars. Further, in 1998, despite revenue shortfalls of 1.2 billion denars, arrears decreased by almost 300 million denars. Presently there is a backlog of payment arrears in FYR Macedonia estimated in 2001 in aggregate, at about 0.4 percent of GDP, of which nearly half represents payments outstanding for over 60 days.

3.15 The only effective method of exercising control over expenditure commitments is mandatory registration at the Treasury of purchase orders before they are placed, recording the anticipated payment flows in the financial plan of the Treasury, and making advance provision of resources in the plan for meeting them. Formal registration in treasury accounts of expenditure commitments and payment liabilities is a normal treasury process in contemporary systems. Monitoring of pre-payment stages of expenditures should be installed in the Treasury during its next phase of development.

3.16 The following measures would assist with this objective:

- Management of expenditure commitments including **pre-registration of purchase orders and recording of the resulting payables** should be an essential requirement of the treasury software and hardware systems being proposed for the next phase of treasury development. This requirement would, among other matters, call for providing access to line ministries and spending units to register their purchase proposals in the system for treasury approval together with anticipated payment flows, and for Treasury to approve the proposals, record the future payment flows in its financial plans and update these from time to time based on the progress of deliveries against the contracts.
- As a **short-term measure to control the existing stock of arrears** (hereafter called old arrears), line ministries should report to Treasury on their old arrears as of a set date, together with details classified according to expenditure code, and offer reasonable proposals, including economizing on discretionary expenditures

and use of their extra-budgetary resources for extinguishing these arrears over the coming months. For the purpose of this exercise, any claim due and legally enforceable for payment on the set date—after factoring in the available grace period for settlement—should be included in the stock of old arrears. Each line ministry should also prioritize the order of settlement of the old arrears providing supporting information on (i) the interest and any penalty liability that would accrue for delayed payment, and (ii) other reasons for according priority. The MOF/Treasury, after careful exploration of the options for funding the arrears, should earmark specified provisions in the monthly expenditure plans exclusively for meeting these liabilities. Amounts earmarked for this purpose should not be reassigned.

- **To prevent generation of new arrears**, procedures should be installed for mandatory pre-registration at the Treasury of selected supply orders above a threshold value, the payment flows arising from which will span more than one monthly expenditure plan. The threshold value should be determined keeping in mind the capacity of the existing treasury software—though prima facie even a simple spreadsheet would be adequate to cover selected high-value supply orders. The anticipated payment flows from these pre-registered orders should be entered in the spreadsheet or other Treasury software, and should get overriding priority in the financial plan for the concerned ministry, to ensure that resources are available when the payments come due.

- The treasury payment system adopted in Macedonia does not require the budget users to submit documents such as invoices supporting payment requests. Similar systems delegating this responsibility to the budget users are not uncommon in developed market economies. In FYR Macedonia, however, the institutions of internal control and internal audit are not adequately developed. In these circumstances, the authorities should consider having the **Treasury assume responsibility for scrutinizing supporting documentation of high value payment claims before authorizing payment**. Administratively this should not be a problem because the Treasury will have regional presence. If, however, this is not considered practicable, urgent steps should be taken to substantially augment the staffing by qualified auditors of the internal audit units in all the ministries and MOF.

- The Government does not currently know what it owns. Property such as land and buildings are registered separately in line ministries, state enterprises, and the general and common services department. A **central registry of fixed assets needs to be established** in MoF and the accounting standards needs to be extended to cover fixed assets over time.

- The government needs to **consolidate the number of first and second line budget users**; e.g. incorporate individual courts, prosecution offices, and prisons as under three umbrella first-line budget units or as programs within a Justice allocation, and then review their account structure and rationalize the accounting organization accordingly. Currently accountability is too dispersed.

Wage Bill Control

3.17 **Wage bill expenditures have been relatively immune to expenditure reduction measures that are imposed when revenues fall.** Generally, transfers and capital have been targeted. Moreover, the wage bill has proven to be prone to overspending, particularly when the salary-related expenditures funded from special revenues are taken into account. Table 3.3 indicates that in 1997 and 1998, where significant revenue shortfalls occurred, wage bill spending met or exceeded the original budgeted amount. In 1999 and 2000, when revenues exceeded projections, the wage bill similarly increased in roughly the same proportion as domestic revenues.

Table 3.3: Actual as Percentage of Initial Budget (Central Government)

	1997	1998	1999	2000
	Actual/ Initial budget	Actual/ Initial budget	Actual/ Initial budget	Actual/ Initial budget
TOTAL revenue	93	97	116	120
Domestic Revenues	93	97	108	111
TOTAL expenditure	99	95	109	115
o/w Wages and salaries	100	103	112	109
o/w Transfers	104	93	105	113
o/w Pension Fund	95	121	102	84
o/w Social programs		89	104	117
o/w Social Assistance program	106	102	114	112
o/w Employment Fund	117	111	100	90

(1) data for 1999 are affected by the unexpected Kosovo crisis.
(2) Source : Ministry of Finance, FYROM.

3.18 **Formal rules aimed at restraining aggregate wage bill and employment levels do exist**[75], but traditionally have left considerable discretion to line ministries regarding the setting of individual salaries and the composition and deployment of their workforce. Recent constraints on this discretion have included the 1999 Government decree that sharply restricted new hiring, the establishment of a uniform salary system under the *Civil Service Law* (not yet fully implemented), the introduction of central review of internal rulebooks and "systematization acts" for each ministry, and collective agreements that guide the setting of pay levels, and types and numbers of posts.

3.19 The Ministry of Finance exerts control over the aggregate central government wage bill, as well as that of each budget user. However, it has traditionally had little if any influence over the sub-components of each budget user's wage bill, i.e. the wage structure and other personnel decisions internal to each organization. As a result, wide discrepancies have existed in wage levels between different ministries (for similar levels or functions). A formal system for authorizing and monitoring numbers of employment posts exists, although it does not appear to function well in practice as it only regulates aggregate employment levels. Despite a legal obligation under the *Law on Budget*, line ministries did not seek this authorization as the surge in

[75] *These include the Labor Code and a 1994 law that imposed restrictions on aggregate wage bill increases*

the 1999 wage bill illustrated. In practice, MOF obtains employment data only from submissions that budget users make in September of each year as part of the process of preparing the next year's budget. The MOF is currently in the process of building a comprehensive database of employment and wages and can now link salary payments to individual positions. Completion of the database is essential for attempting to equalize wages across ministries in implementing the *Law on Civil Servants* (see Chapter 4).

3.20 The following recommendations aim at strengthening the Ministry of Finance's role in aggregate wage bill control:

- In compliance with the *Law on Budget*, **proposals from line ministries to hire and/or to increase salaries should be submitted for comment to the Ministry of Finance** prior to being submitted to the Government for approval. In fact, the new requirement to complete a mandatory fiscal impact assessment will flag cases where additional wage costs are being requested.

- With the improvements made to the Treasury's register of employees, a useful tool now exists for controlling employment and wage-related costs.

  (i) The **Ministry of Finance should closely monitor and control wage costs for all budget users on a monthly basis** (both 1st and 2nd line) through the register. Specifically, budget users should be obliged to notify MOF of changes every month so that the data always correlates to the monthly payment order for salaries (this practice has been initiated by the MOF). If they do not, the MOF payments should not be approved.

  (ii) The MOF should also use the register to monitor and **eliminate double counting and fraud in salary payment** by:

a. Spot checking the ID numbers of each employee to ensure that there are no erroneous payments to individuals who should have long since retired. The ID numbers could be cross-checked with the Ministry of the Interior's records.

   a. Checking the employee's home address against his work address. This would permit checking whether an individual is erroneously receiving a transport allowance to and from work.

   b. Spot-checking educational certificates where part of an individual's pay is dependent on the individual's level of education.

   c. Identifying employees who are working for more than one budget user on a part-time basis.

Overview

3.21 Chapter 1 outlined the fiscal challenges facing the health sector and some key policy directions that need to be pursued. In this chapter, the financial management and control issues will be addressed in more detail, including improving internal systems of management, resource allocation and control within the Health Insurance Fund (HIF) and public health care provider network. The Health *Insurance Law* (HIL) passed in April 2000, provides the framework for establishing systems of budgeting, financial control and reporting within the HIF. It provides for supervision of the HIF by the Ministry of Health (MOH) and by a Board on which the Ministry of Finance is represented. The Law gives the HIF powers to institute a system of contracts, financial controls and financial reporting requirements for the public health care providers. These institutions are predominantly funded by the HIF. In order to give effect to the Law, by-laws must be developed, with associated systems and procedures. The HIF and MOH have made progress in developing bylaws and contracts in some areas since the passage of the Law (see Chapter 1). As well, the MOH and the HIF need to develop increased capacity to carry out their new financial management responsibilities and to enhance the financial management information systems in their organizations to support this. The HIF and MOH have embarked upon a range of training initiatives for staff and other key stakeholders in the health sector in health finance and contracting. Plans for a more intensive training and development program are now being designed.

3.22 In recent years, general budget revenues have only been transferred to the fund for a small number of national preventive programs, typically amounting to less than 2 percent of revenue. Some modest benefits will be achieved by increasing the co-ordination and comparability of the HIF's budget processes and financial reporting with the budgeting and financial reporting systems of the general Government budget and by improving the MOF's and MOH's capacity to monitor and review HIF finances. These latter measures offer only weak levers for dealing with financial problems in the HIF, which are no substitute for effective internal control. At this time, there appears to be little to be gained by full integration of the HIF into the budget, and indeed some risk that such a step would reduce the credibility of the revenue constraint on the Fund.

Strengthening Financial Management and Control in the HIF

3.23 The HIF has now adopted new Budget Preparation and Execution guidelines and a new Chart of Accounts, now approved by the MOF, in order to further the objectives of improved coordination and comparability of budget processes and financial reporting. This provides a basis for strengthening and making more transparent the financial management of the health sector. However, staff training, financial management information systems development, and supervision arrangements (supervision of HIF by MOH, and supervision of HIs by HIF) also need to be strengthened to give full effect to the new regulations.

3.24 In the past, the HIF was unable to implement a systematic budget planning and forecasting system for the publicly funded health system. The HIF lacks capacity and management information systems for forecasting, budget analysis and control. The Government put strong pressure on the HIF to bring its finances into balance following accumulation of significant debts by the end of 1998. In 1999, the HIF reported that it achieved financial balance, predominantly through sharp cuts to spending on health care institutions assisted by strong revenue growth. The expenditure cuts do not appear to have been accompanied by significant structural changes in health care providers, and there is some evidence that they resulted in sharp increase in debts of HIs and some increase in out-of-pocket payments. As a result, it seems clear that the system as a whole remains in a financially unsustainable situation.

3.25 On the revenue side, forecasts of payroll contributions and transfers from other Funds are obtainable from respective Government agencies responsible, and collection via ZPP[76] (for payroll contributions) and other Funds is technically straightforward for the HIF. At present, arrears in collection from these sources is not a significant issue. Some risks are posed for HIF revenues by the Government's decision to dismantle ZPP and transfer its revenue collections to the Public Revenue Office. The key problems for the HIF on the revenue side appear to be: weakness in collection of contributions from farmers and self-employed (which is the responsibility of district HIF offices), lack of timely and accurate information about the "special revenues" of public health providers, and lack of use of information about this revenue in determining allocations to public providers.

3.26 On the expenditure side, in theory, providers are to be paid on the basis of invoices for services provided, classified according to a German-style points system. In practice, because the HIF (like every health system which has tried this method of reimbursement) was unable to control expenditure under this complex and open-ended system. Public providers are not paid on this basis, although they do submit and tally invoices based on this system. There is widespread confusion in the health sector and within central Government about this – many people are under the misapprehension that the invoice system is operational, and that the reported arrears of the HIF to providers based on this system represent a significant financial liability. These invoices are unchecked, and are reportedly very inaccurate, tending to over-invoice. MOF reports health expenditures using this inaccurate basis for reporting the shares of health expenditure by different categories of services. Moreover, the points system and associated tariff structure is used to pay only a small market of contracted private providers (accounting for only around 2 percent of expenditure, but growing fast) and as the basis for official user co-payments for the insured and charges to the uninsured.

3.27 Public providers are reimbursed by the central HIF on the basis of the costs of various categories of inputs. Some input categories are subject to central control. Salaries for staff and the number and appointment of staff are subject to MOH approval, although the MOH has approved rising staff numbers in a system which is clearly overstaffed. Fixed amounts are allocated to meet non-salary operating costs (utilities, food, other consumables), largely on the basis of historic expenditure with some adjustment. An unsustainably small allocation is made for repairs and maintenance and capital expenditure, though other sources of financing are available for capital expenditure. However, there are reports of inappropriate duplication of expensive equipment in some places, while basic buildings and equipment are in very poor repair in other places. This input-based system of allocation is reasonably effective at achieving aggregate control over cash expenditure, but fails to create incentives for allocative or technical efficiency.

[76] Former ZPP functions are assumed by the Public Revenue Office.

3.28 Some areas of expenditure were uncontrolled until 1998: pharmaceuticals expenditure in hospitals and primary care, payments to private providers, and reimbursements to insurees for a range of cash benefits and entitlements (including free eye glasses, prostheses and orthopedic appliances). As mentioned earlier, arrears rose to denars 1.2 billion in 1998 and again to approximately 1 billion in 2001.

3.29 Public health care providers report expenditure using a form of accrual accounting, based on the accounting conventions of the private commercial sector in Macedonia. It is not clear how timely or accurate this information is for the HIF to use as a basis for budgeting and financial control. The information systems of providers and district offices of the HIF are not linked electronically. Aggregate information is compiled at provider and district level, and sent manually to the central HIF.

3.30 The HIF prepares an annual bulletin, reporting the expenditures and revenues of the HIF and public health providers, and providing some analysis. This is forwarded to the MOH, and freely available to interested parties, but it is not clear that anyone does anything with this information. The MOF does not appear to receive or use this information for monitoring, though under the draft new HIL, the MOF will have a representative on the Board of Directors of the HIF.

3.31 As outlined in Chapter 1, the HIF has begun to implement reforms to address some of the above issues, under the framework of the *Health* Insurance *Law* (April 2000). Additional recommendations specific to financial management and control include:

- **Developing a Treasury system.** The HIF Director has considered plans to improve the timeliness and accuracy of the information available to him about revenue and expenditure by implementing a similar treasury control system to that used by the MOF for budget agencies. At this time, the HIF has commenced investment in upgrading its hardware and software platform for its information systems, but the procurement of Treasury system software is waiting for MOF to acquire or develop its own system, which may provide a suitable option for HIF to adapt to its own use.

- **Preparing a plan for improving accuracy and appropriateness of health providers' information.** The usefulness of the MIS development will depend critically on the accuracy and appropriateness of the basic data which the HIF receives from public providers. Unless HI financial and activity information is improved, and financial management systems, training, and audit are undertaken in HIs, there will be limited gain from the HIF developments.

- **Assess procurement of pharmaceuticals.** The HIF's 1997 centralized procurement of pharmaceuticals resulted in prices that are three to four times higher than prices which have been obtained by international procurement under the Health Sector Transition Project (Credit No. 2889-MK). It would be useful to review the procurement processes and capacity in the HIF and HIs to identify strategies for achieving competitive international prices.

3.32 The issue of monitoring and control extends beyond financial management and the operation of an effective Treasury. A reliable system of budget formulation, as proposed in chapter 2, needs to be reinforced through regular monitoring and reporting to the Government with respect to achieved vs. expected results against the government's policy priorities and its fiscal plan. At the line ministry level, senior management must ensure that monitoring and reporting systems are in place to assess ministry progress towards achieving their objectives. Results will seldom be achieved if a static approach to intervention during the year is followed. On the other hand, the monitoring systems should not be so prescriptive or input-oriented as to preclude flexibility towards achieving the desired results.

3.33 Tracking policy commitments is not unfamiliar in FYR Macedonia. *The First 100 Days* contained a long list of legislative and regulatory commitments, including deadlines. The Government's *Rules and Procedures* obliged ministers to meet these deadlines. The General Secretariat closely tracked ministry progress in meeting these and at the end of each month sent out letters to ministries asking for an explanation when the deadline had not been met. This monitoring allowed the Secretary General to track progress in achieving the Government's program. However, there was no regular reporting back to the Government on progress, although the Prime Minister did use this information as the basis for meetings with individual ministers. Moreover, **there is no system that formally tracks the implementation of all government resolutions.**[77] The General Secretariat's strategic plan, approved by the Government in 2001, stated the intention to establish a formal monitoring function.

3.34 Systematic budget monitoring does occur within the Ministry of Finance. A fiscal report is provided at the outset of the budget process indicating progress towards achieving expenditure, revenue and deficit targets during the current year. However, **there is no regular reporting mechanism back to the Government on progress towards meeting fiscal projections throughout the year**. Beyond the aggregate fiscal level, it is important to monitor and report on discrete elements of expenditure, such as the wage bill, capital expenditures, municipal spending, transfers, and debt payments. Such reports can be instrumental in allowing the Government to react more quickly and strategically to changes in the fiscal outlook.

3.35 **Neither fiscal nor policy monitoring systems extend to issues of policy quality or results**. Too often, governments equate the decision to approve draft legislation with concrete achievements. On the contrary, these serve only to indicate intention. As policy development is improved so that ministers are provided with expected impacts and results for policy and program proposals, monitoring systems should be similarly expanded in scope. Moreover, this information needs to be integrated with the critical government deliberations on priority and budget deliberations. Periodic formal reviews by Government of achieved vs. expected results can be extremely useful in determining where attention should focus in future years. Ideally, this information should be communicated to Parliament and the public.

3.36 Little has been said here with respect to formal policy or program evaluation. This will come at a later stage of development where experience with results reporting has been gained

[77] Two African countries discovered, with the introduction of decision monitoring systems, that 75 percent and 67 percent of their cabinet decisions remained unimplemented. N. Manning; Strategic Decision-Making in Cabinet Government; op. cit. p. 13

and capacity in central agencies, ministry policy departments, and internal audit is strengthened. Civil society and academic groups can play an important role in the evaluation process.

3.37 The following recommendations would strengthen monitoring and reporting in FYR Macedonia. The point of departure should be to use this to assist decision-making, not simply to exert control.

- Establish a monitoring unit in the General Secretariat;
- Develop protocols for regular (at least quarterly) reporting to the Government by the General Secretariat and Ministry of Finance on progress against policy priorities and the fiscal plan;
- As part of these quarterly reports, the General Secretariat will include an assessment on the progress of Government legislation in Parliament, identifying if any significant backlogs or individual problems are occurring;
- As part of these quarterly reports, the Ministry of Finance will include a report on budget execution by ministry and budget line, including arrears; this should be prefaced with an analysis and recommendations from the Ministry of Finance;
- Place all Government resolutions on the internet;
- The Ministry of Finance should prepare a monthly report and analysis of actual revenues against original budget targets; if a significant deviation is occurring, this should be reported to the Government; the report should draw on data provided by the Department of the System of Taxes and Fees and the Public Revenue Office;
- The MOF (Budget Department) should develop a capacity for analyzing emerging tax trends so that it can produce revisions to the Budget targets and accordingly advise the Government on a quarterly basis.
- These measures should permit improved reporting to Parliament. Ideally, the fiscal strategy paper for the upcoming budget, along with data and analysis on actual vs. budgeted revenues and expenditures from the previous year and year-to-date of the current year should accompany the annual budget bill to Parliament.

EXECUTIVE ACCOUNTABILITY

3.38 Any effective executive accountability framework contains strong internal and external checks and balances. The strength of internal accountability will be reflected in at least three key areas: (i) whether the Government holds itself to account; i.e., the degree to which it sets clear objectives, openly reports on the results achieved, and rewards or sanctions Ministers and senior management on their performance; (ii) whether the public service is held to account for its performance; i.e., is a meaningful and fair personnel performance evaluation system in place; and, (iii) whether institutions exist within the public service to identify compliance with the norms and standards set to guide public service performance; i.e., internal audit. With respect to external accountability, three critical dimensions include: (i) accountability of the Executive to the Legislative and Judicial Branches; (ii) the existence of a robust external audit system; and (iii) a strong public accountability framework where civil society, the media, and the general public have access to the necessary information and avenues to influence the development and delivery of public policy.

Internal Accountability

Public Reporting of Government Objectives and Results

3.39 This issue brings together several strands from different sections of this report. In Chapter 2, the consequences of failing to set clear priorities were described. Earlier in this chapter, gaps in financial management and monitoring mechanisms were identified. Chapter 4 outlines how the civil service's human resources management framework militates against clear and objective lines of accountability. All of these elements describe a system that needs to set as a fundamental priority the establishment of a regime where clear public policy objectives and results are routinely planned, monitored, and publicly reported.

3.40 Unquestionably, FYR Macedonia has begun to develop some rudimentary mechanisms in this regard. Formation of a Treasury continues to improve public accounting and reporting. The revised *Law on Budget* brought special revenues into the budget and improved reporting on extra-budgetary funds. New reforms in the budget formulation process will lead to priority-setting at the government level and, ultimately, to program priorities at the line ministry level. All of this sets the stage for creating a performance orientation in the civil service as well as improved reporting to Parliament.

3.41 Realistically, these reforms remain in their infancy and have yet to make a significant impact on the accountability of line ministries. The 2002 budget circular did include the requirement for information on programs undertaken by line ministries along with program objectives and even reporting of results against stated objectives. However, excepting two ministries that received technical assistance, the resulting program structures and objectives were not articulated in a way that would permit meaningful assessment of results. The Government has committed to improvements in this area for the 2003 budget process.

3.42 Until the Government and line ministries are able to identify meaningful priorities, based on policy trade-offs, as part of the budget process, it will be difficult to make progress in this area. However, as suggested in chapter 4, this is not strictly a technical or legal issue. Accountability for performance is equally a human resources management issue.

Performance Evaluation

3.43 The issue of performance evaluation in developing countries is complex as it relies on systems of information and management that are rarely in place. It can be counterproductive to expend enormous effort to institute a labor-intensive process that ultimately depends on the subjective opinions of political appointees concerning the relative merit or value of an individual civil servant's performance.

3.44 Chapter 4 explores this issue in more detail as it relates closely to significant issues regarding human resources management across government. Although it is clearly too early to institute a service-wide system, the fundamental requisites for such a system are being put in place:

- an oversight agency (Agency for Civil Servants) that can adjudicate issues of impartiality and fairness;

- improvements to the budget process that require the establishment of government and ministry priorities and program objectives and expected results;
- a uniform pay system, a prerequisite for pay for performance, is being implemented; and
- organizational structures (State Audit Office and the Internal Audit Department) that will conduct external and internal audits.

3.45 Notwithstanding these measures, the institutionalization of performance management requires that management and delegation systems exist that can meaningfully articulate how government or ministry priorities should be reflected in the performance contracts of individual employees. Although a long-term undertaking, steps at both the corporate and individual levels need to begin to instill performance as a driver of civil service behavior.

Internal audit

3.46 Ex post control, through internal audit, has been established to ascertain (i) whether the amounts spent were for intended purposes; (ii) whether commitments were made in accordance with the *Law on Budget*; and (iii) whether funds were used efficiently.

3.47 The Ministry of Finance has formed an internal audit department with 10 staff. This followed an initial, unsuccessful attempt, where staff trained in internal audit were appointed elsewhere in the ministry. At this staffing level, it will be difficult to cover the full range of institutions eligible for such audits. Ultimately, it may be advisable to appoint a Chief Internal Auditor to be responsible for establishing the internal audit function across the public administration, including methodology, professional development, coordination with other auditors, and performance evaluation.

3.48 Once a core body of trained internal auditors exists within the Ministry of Finance, and a standard methodology has been developed, internal audit units can then be established within key line ministries and institutions. A small, central unit in the Ministry of Finance should remain to ensure that uniform internal audit standards are applied consistently and assist with the actual conduct of internal audits in smaller government units requesting such services. The central unit will also provide functional advice and support to line ministry units, provide dispute resolution services, and oversee the quality assurance process.

External Accountability

3.49 A strong internal accountability framework is a necessary but not sufficient guarantee of an accountable executive branch. Effective public sector performance depends equally on external pressures, including the broad pattern of checks and balances between the Executive and the legislative and judicial branches, the presence of an external audit function that can independently scrutinize the executive's own accounts, and on the role of civil society and key external actors including the media and the academic community. In reviewing these external pressures on the executive, it is important to go beyond the issue of their relative authority or influence to ensure that the necessary level of transparency and quality of information exists to enable them to fulfill their roles.

3.50 In this regard, the World Bank Report on Stability and Prosperity in SEE states that: "Holding the executive to account rests on two foundations: answerability and enforcement.

First, there must be some bodies or groups that the executive must answer to. Complaints about the behavior of the executive from the electorate, legislature, interest groups, judiciary, political parties, procurators office, the media, audit body, civil society groups, local government and the donors must matter. Second, the executive must be required to change course in certain circumstances. If the answers that it provides are not seen to be satisfactory then, in some situations, it must be possible to enforce alternative behavior."[78]

Legislative and Judicial Branches

3.51 The potential influence of Parliament on the Executive in FYR Macedonia is significant. As graph 3.1 underscores, Parliament is in a strong position to dismiss the Government. With respect to holding the Government to account, however, the Parliament has traditionally been hampered in this role owing to the poor quality and lack of timely information being provided.

3.52 According to the *Law on Budget*, the Ministry of Finance is required to submit a final account of the state budget, together with the final accounts of the budgets of the self-governed units and the funds, for adoption by Parliament. In the past, the information was presented at such a high level (no breakdowns below the budget user level) that it was not possible for Parliament to provide any meaningful scrutiny. Problems such as special revenues and unauthorized guarantees further compounded this issue.

3.53 With the formation of the Treasury, financial reporting to Parliament has improved dramatically. Now, all special revenues, guarantees and extra budgetary funds are reported to Parliament as part of the budget documentation and final accounts. However, the same level of information is not yet provided for non-financial information. Neither budgets nor the final accounts provide any analytical information to help parliamentarians understand how or why the money was spent, or what results were achieved. If implemented, the 2003 budget reforms, which include the preparation of a budget strategy paper, will contribute to bridging this gap.

3.54 The judicial branch remains weak in terms of its role in holding the executive branch to account. In 1997, the WDR rated the predictability of the judiciary in FYR Macedonia significantly below that of Czech Republic, Hungary, Poland, and Slovakia. Furthermore, the index deteriorated in FYR Macedonia between 1993-1998.

External audit[79]

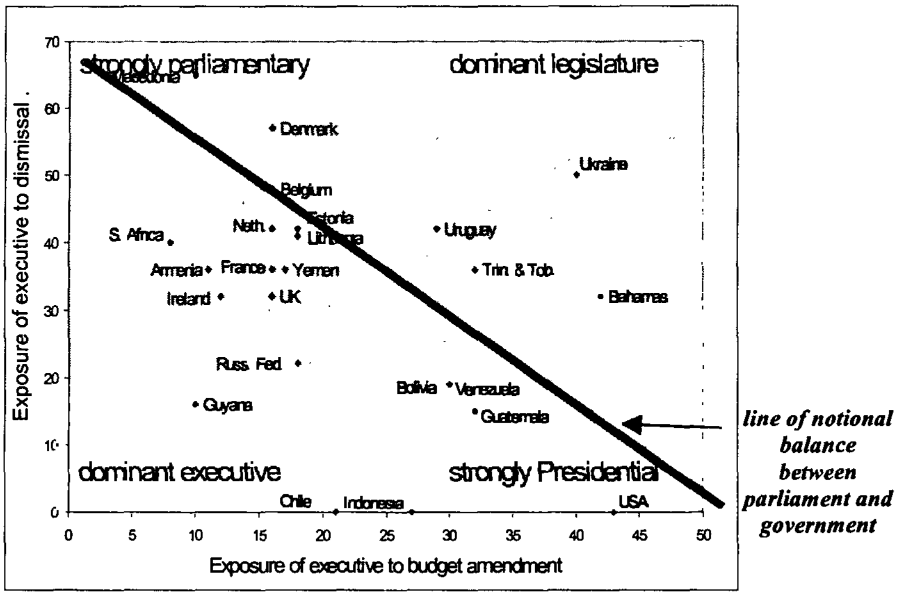
3.55 The 1997 *State Audit Law* represented a significant advance as it was comprehensive and reflected the standards of the International Organization of Supreme Audit Institutions (INTOSAI). It provided for:

- audit of all public entities, including those at the local level of government;
- broad scope audits, including matters of economy, efficiency and effectiveness;
- free access to needed information;
- independence of the State Audit Office in planning, conducting and reporting audits;
- appointment and dismissal of the Chief State Auditor and Deputy by Parliament;

[78] Source: "The Road to Stability and Prosperity in SEE", A Regional Strategy Paper, World Bank, March 2000.
[79] For a more detailed discussion on audit, see Annex 3.2.

- term of office for 10 years, thereby covering two government terms;
- requirement to follow auditing standards;
- penalties for entities and responsible persons who limit the audit in any way; and
- reporting to Parliament.

Graph 3.1: ***Balance of Executive and Legislative Powers***



3.56 Article 12 requires the SAO to submit its annual audit report to Parliament. This report summarizes the audits conducted during the preceding year and reports on the work of the State Audit Organization. It is reviewed by the Parliamentary Finances and Budget Committee. The first such report was submitted to Parliament in 1999. INTOSAI audit standards have now been published and the SAO has been conducting its audits pursuant to these standards. Recently a Code of Professional Conduct was prepared consistent with the INTOSAI guidance.

3.57 Having strong audit legislation is important, but implementation presents a different challenge. The Law does not require the inclusion of recommendations in audit reports (nor does it prevent their inclusion). It also does not provide for "follow-up" of actions taken by audited entities to correct reported weaknesses, nor does it require the SAO to adopt a "quality assurance" process to assure itself that audit standards and processes are followed in the conduct of its audits. These matters could be addressed through internal policy decisions by SAO.

3.58 Since 2001, initial steps have been taken to organize the SAO and a plan has been developed, supported by technical assistance, to extend its audits over all entities under its jurisdiction within three years. A major obstacle in implementing the plan has been the low number of SAO staff and the difficulty of recruiting qualified new staff. From a base of 11 staff (Chief State Auditor, Deputy State Auditor, 7 auditors, 2 administrative support staff) in 2001, 10 new staff have since been recruited (7 auditors and 3 support staff). Although positive, this falls far short of the SAO's own assessment that it needs 74 auditors to implement fully its plan.

Public Accountability: Civil Society, Media

3.59 A potentially strong influence on executive behavior derives from informal, or public accountability systems; namely civil society, the media, and the general public. In FYR Macedonia, these informal influences are, at best, uneven. Table 3.4 indicates that FYR Macedonia ranks fourth on average with respect to various types of accountability mechanisms compared to neighboring countries.

Table 3.4: Selected Indicators on Political Process, Accountability and Participatory Institutions

		Albania	BiH	Bulgaria	Croatia	FYRM	Romania	Hungary
1	Political processes	4.50	5.00	2.75	4.25	3.50	3.25	1.25
2	Civil society	4.25	5.00	3.75	3.50	3.75	3.75	1.25
3	Independent media	4.75	4.75	3.50	4.75	4.00	4.00	1.25
4	Voice and Accountability Index	-0.01	-0.97	0.6	-0.32	0.09	0.41	1.20

Higher numbers indicate better governance for row 4, and worse governance for rows 1,2 and 3.
Source: "The Road to Stability and Prosperity in SEE", A Regional Strategy Paper, World Bank, 2000.

3.60 These results are not surprising as most of the mechanisms for engaging civil society or public participation in the executive's policy process are missing. For example, budget preparation is not discussed outside government or submitted to prior external review by NGOs or academics inside or outside the country. Government respondents to a questionnaire indicated that sector priorities were not at all influenced by the business community, public interest groups, labor unions, farmers' associations and other interest groups. Although IFIs and donors provide another source of checks on the system, this function is far from adequate and is never intended to substitute for national checks and balances.

4. HUMAN RESOURCE MANAGEMENT

INTRODUCTION

4.1 A key message emerges from the preceding chapters: policy decisions have a pronounced and unfortunate tendency to be driven by immediate pressures, almost to the exclusion of consideration of longer term considerations, such as fiscal and institutional sustainability. Countries that experience policy volatility typically focus on immediate pressures rather than longer-term objectives and, consequently, experience lower economic growth rates and lower levels of investment.[80]

4.2 This chapter complements the previous chapters of this report by examining policies and practices in the management of public sector human resources. The analysis has four major aims. First, we present evidence that this same pattern of policy decisions driven by short-term considerations impacts public sector human resource management as well. Second, we examine the human resource management institutional arrangements and practices. Third, this permits us to identify some important reasons why the institutional arrangements governing human resource management within FYR Macedonia's central administration currently fail to adequately focus agencies and their personnel on longer term policy objectives. Finally, we offer recommendations for actions the Government should consider undertaking in order to address the human resource management weaknesses identified in the chapter. Those recommendations fall into three broad areas: (i) improving pay and employment structures; (ii) establishing the legal, institutional and management framework required to create and maintain a professional, meritocratic, performance-oriented civil service; and (iii) implementing this new human resource management (HRM) framework within a smaller, more affordable organization focused on core activities.

PAY AND EMPLOYMENT ISSUES

4.3 With respect to pay and employment, two key issues were presented in Chapter 1. First, **FYR Macedonia cannot afford its current level of public administration.** Although, compared to neighboring countries, FYR Macedonia's public employment levels are not excessive relative to population (Table 4.1 outlines public sector employment levels), the country's higher poverty level means that it outstrips other Central and Eastern European countries in terms of general government wage expenditures relative to both total expenditures and GDP.

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[80] *The State in a Changing World: World Development Report, 1997* (The World Bank: Washington, DC, 1997).

Table 1.4: Government Employment in FYR Macedonia, 1998

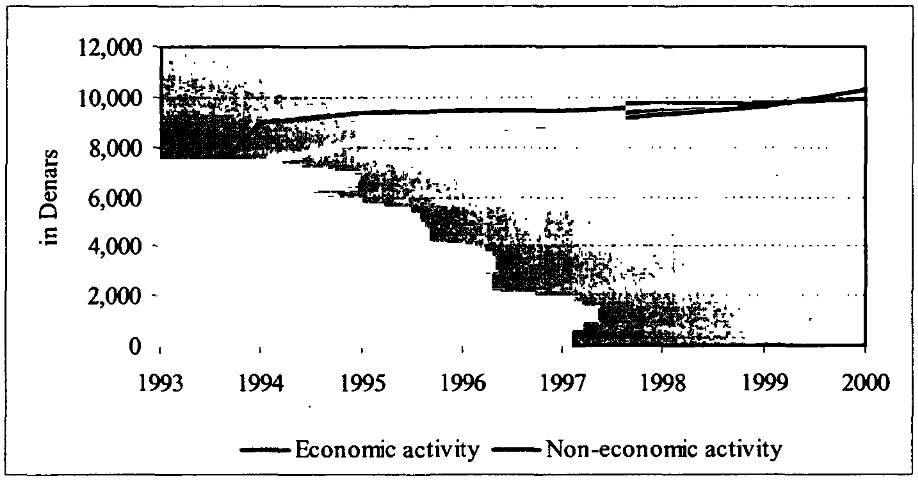
Entity	Employment	% of total
Central Budgetary institutions, total*	68,903	72.9
Ministries of Defense, Interior	16,622	17.6
Ministries exc. Defense, Interior	5,464	5.8
Other	46,817	49.5
Extra-Budgetary Funds, total	1,597	1.7
Pension Fund	600	0.6
Employment Fund	422	0.4
Road Fund	25	0.0
Health Fund	550	0.6
Health Institutions	24,037	25.4
Total*	94,537	100.0

*Excludes Intelligence

Source: Ministry of Finance. Health Institution data is from the Ministry of Health's Health Insurance Fund. Employment in Extra-Budgetary Funds is assumed to be unchanged from 1997 IMF data.

4.4 Second, **high but steadily declining average public administration salaries (see Figure 4-1) mask a salary structure that impedes the public sector's capacity to attract, motivate and retain key skills.** Salaries in occupations (e.g., financial management) critical to reform are decreasingly competitive with the private sector, a pattern that has been observed in other developing countries.[81] This pattern suggests that an important element of any effort to improve the performance of FYR Macedonia's public administration will require employment reductions coupled with salary reform designed to improve the competitiveness of remuneration among the higher skilled ranks. **Salary restructuring should also ensure that remuneration among the lower skilled ranks does not rise in nominal terms throughout the period in which the salaries of higher skilled positions are being made more competitive.**

Figure 4.1: Average Monthly Wages, 1993-2000



[81] See, for instance, Gary J. Reid and Graham Scott, "Public Sector Human Resource management: Experience in Latin American and the Caribbean and Strategies for Reform," Green Cover Report No. 12839, Public Sector Management Division, Technical department, Latin American and the Caribbean Region (World Bank, Washington, DC: March 14, 1994).

Source: Statistical Office of Macedonia

4.5 No standard salary scale has yet been implemented across the administration. In practice salaries for roughly equivalent jobs appear to be reasonably comparable, in large part due to tight fiscal constraints that effectively prohibit organizations from raising overall pay levels or from awarding pay increases. Salaries for actual existing jobs are set at the organization level using a system that dates back to the socialist era. This system assigns points to each job based on factors such as complexity, level of responsibility, educational requirements, and working conditions. The point system applies to all posts except those of higher officials, whose pay is set separately. While the factors considered in assigning points, as well as the value of each point, appear to be fairly consistent across the administration, the actual evaluation of posts is done by each organization's head (subject to Government approval) and recorded in the organization's internal regulations.

4.6 The *Law on Civil Servants*, passed in July 2000 and amended in April 2001, mandated a uniform and less compressed salary structure for all civil servants, to take effect January 1, 2002.[82] The number of positions covered by this Law is still unknown, but estimated to be between about 8,500 and 20,000, or roughly 15 percent to one-third of general government employment. **For the salary structure mandated by this Law to meet its objectives, the Government will have to make significant net employment reductions within overall general government employment prior to the effective date of that new salary structure.** Otherwise, that new Civil Service salary structure will have to be pegged too low to significantly enhance the attractiveness of employment within the higher ranks of the civil service.

4.7 Other opportunities to enhance pay are said to be infrequent or non-existent, except in the rare event that an employee is promoted to a higher post (which generally occurs only after a corresponding vacancy arises). However, it should be noted that, formally at least, provisions for salary enhancements are detailed in regulations of at least two ministries.

4.8 **Pay levels in the administration are severely compressed.** Professional staff face weak financial incentives to take on senior positions that carry greater responsibilities and require more advanced skills. The pay scale for higher officials—which applies throughout the administration—essentially serves as the cap for wages of staff below this level. As a result, compression ratios across organizations are fairly comparable. Estimates from individual ministries indicate that an undersecretary (one of the most senior posts) might earn roughly 2.3 to 3.1 times more (net, including allowances) than the lowest-paid employee such as a cleaner. This compression ratio is more extreme than those found in some other post-communist countries which themselves suffer from compressed wage structures[83]. It is certainly far lower than compression ratios exhibited in OECD countries such as the UK (9.8), France (5.7), United States (8.9) and the Netherlands (8.2).[84] Effective implementation of the salary structure mandated by the revised Law on Civil Servants could help to address this problem.

[82] The date of effectiveness of the new salary structure has since been postponed until January 1, 2003, in order to permit adequate time to make the employment reductions required to allow financing of the new salary structure within a fiscally sustainable wage bill envelope.

[83] For example, the Czech Republic, with a compression ratio estimated by the World Bank at between 4.4 and 5.1. See *Czech Republic: Toward EU Accession*, World Bank, 1999.

[84] *Ready for Europe: Public Administration in the EU Accession Context*, the World Bank, forthcoming.

4.9 Determination of actual wage levels is complicated by the decentralized wage-setting approach described above, as well as other data constraints such as the limited coverage of the statistical office's wage survey. Nevertheless, estimates obtained from several ministries indicate net basic monthly salaries (excluding allowances) equivalent to approximately US$375 for an undersecretary, US$160-170 for a new university graduate, and US$75-110 for a cleaner. Additionally, all staff receive a food allowance of US$40 (2,300 denars) per month, and eligible staff can receive a transportation allowance of up to US$16 (900 denars) per month.[85] Positions can also be classified as "specific posts", allowing wages to be set at a higher rate; this is the case, for example, with administrative inspectors at the Ministry of Justice, labor inspectors, and certain posts in the ministries of Interior (police officers), Foreign Affairs, and Defense. Finally, the Government has at times chosen to increase the pay of staff in selected ministries. This was the case during the spring 1999 crisis in neighboring Kosovo, when the Ministry of Interior received an across the board increase of 20 percent of net salary, and Ministry of Defense staff were reported to have received special payments between two and three times over the balance of the year.[86]

4.10 The relationship between pay levels in the public administration and in the private sector is complex and unclear as little evidence is available. Given the great variation and limitations of available pay data, it is important to exercise caution in drawing any conclusions about relative pay levels or the appeal of private versus public administration jobs. However, a number of possible interpretations should be considered.

4.11 First, the competitiveness of public administration pay levels appears to vary according to rank, a phenomenon that has been observed in other developing or transitional countries. Second, pay at lower-levels appears to be competitive with that in the private sector, particularly after taking into account the relative job security afforded by the public administration compared to the uncertainty in the private sector, which is reported to be high. At the same time, at senior levels pay appears to be less competitive with the private sector, particularly for staff with highly desirable skills, for example in the financial field. Indeed, there is anecdotal evidence of senior staff in the Ministry of Finance moving to private sector positions paying two or more times as much as the Ministry, as well as of promising young professional staff leaving after having enhanced their experience with a short stint at the Ministry.

4.12 **Departures from the public administration are, for the time being, constrained in practice by the scarcity of appealing private sector opportunities**, given the state of FYR Macedonia's economy and private sector development[87]. The reasons generally cited for the low number of departures from FYR Macedonia's public administration include high risk and

[85] The share of these allowances in total earnings constitutes approximately 25 percent for a new university graduate but declines to about 13 percent for an undersecretary. In comparison, allowances are non-existent or less than 1 percent of total earnings in Australia, Canada, Denmark, Iceland, Ireland, Portugal, Sweden, Switzerland the United States and the United Kingdom; 5-25 percent in France; 10-30 percent in Germany; 0-7 percent in the Netherlands. See Trends in Public Sector Pay in OECD Countries, OECD, 1995.

[86] The Ministry of Interior increase, funded from the budget and special revenue, as well as donor funds related to the Kosovo crisis, started in April 1999, and as of one year later had not been rescinded. The Ministry of Defense has been funding special payments from revenues received from donor organizations.

[87] Although no official data is published, reports from several government bodies indicate that staff turnover is extremely low. For example, staff in the Ministry of Finance estimate that there might be 10-15 departures per year out of about 1,500 employees, a turnover of about 1 percent. In comparison, turnover rates for the public administration are estimated at 2-3 percent for federal employees in Canada, 6-8 percent in the United Kingdom, 4 percent in the Netherlands, and 8-10 percent in Sweden's central government.

uncertainty in the private sector, as well as the high unemployment rate. Excessively high staff turnover has detrimental effects due to the loss of experienced staff and institutional memory as well as the costs associated with recruiting and training replacements. On the other hand, excessively low turnover means that there is little opportunity to renew the skills base by attracting staff with up-to-date qualifications or exposure to new ways of thinking. This concern is particularly relevant for transitional countries such as FYR Macedonia, where work methods and morale were for decades subject to the ideology and prevailing incentives of the socialist system.

4.13 Recent pay and employment policy decisions illustrate the tendency of FYR Macedonian authorities to base important policy decisions more on immediate pressures than on more stable strategic priorities.

- The decision approving wage hikes and employment increases occasioned by the Kosovo crisis in the Ministries of Defense and Interior was taken without consideration of the outer years' effects of this increase, and/or the risk of spill-over to other ministries. These initiatives tend to underscore (i) the Government's difficulty in enforcing cohesive policies and actions; and (ii) the absence of overall assessment of the impact of policy decisions. Once implemented, the new fiscal impact assessment requirement will address this issue.
- The early retirement law approved in 2000 was passed partly to offset the above increases and partly to respect a wage bill cap agreed with the IMF for 2000. While the early retirement proposal proved the most feasible solution in the short term, it was not underpinned by a cost benefit analysis, nor did it take into account the cost to be incurred by the Pension Fund in outer years. Moreover, when the law was overturned by the courts, the Government was forced into an equally short-term focused response to downsize employment in 2000.

ESTABLISHING A LEGAL, INSTITUTIONAL, AND MANAGEMENT FRAMEWORK FOR THE CIVIL SERVICE

Legal Framework and Organizational Objectives

4.14 In a well-functioning administrative system, human resources will be used to implement the long-term strategic objectives of the government as a whole and, consistent with that, of the individual government organizations. As shown by the preceding chapters of this text, these strategic objectives will be set through legitimate decision-making processes that integrate policy priorities with fiscal constraints. With this in mind, one can imagine the administration as a series of nested, interdependent levels, all building toward the common aim of meeting such stable, carefully-considered strategic objectives. For example, each ministry will have clear and legitimate objectives (agreed with cabinet and parliament) that serve as the drivers of its organizational behavior and activities. At the next level down, each department or program will also have its own strategic objectives (consistent with the organization's) against which its performance is measured and for which it is held accountable. Similarly, managers will channel their activities toward accomplishing departmental and organizational objectives and staff, in turn, toward meeting the valid objectives conveyed to them by their managers. At each of these levels, institutional arrangements will both facilitate and monitor progress in achieving objectives. Thus institutions[88] for managing human resources will promote employee performance in a manner that contributes to effective, efficient programs and delivery of services.

4.15 Many of the ills currently exhibited by the administration's human resources system can be seen as the manifestation of reactive (rather than strategic) policy-making tendencies. **Lacking a solid, long-term vision, the existing system exhibits fundamental weaknesses in the legal, institutional, and management systems that effectively define the playing field and rules of the game for the workforce.**

4.16 The legal and ethical framework for FYR Macedonia's public administration remains in a state of transition from an outmoded, socialist-era system (now partly dismantled) toward one comparable with frameworks found in European or OECD countries. FYR Macedonia has passed a number of important laws establishing a more modern legal framework for public administration. These include the *Law on Civil Servants*[89], the *Law on Organization and Work of the Administrative Bodies*[90], the *Law on Government of the Republic of Macedonia*, among others. The *Law on Civil* Servants and its subsidiary legislation establish a uniform legal framework governing all civil servants. Key provisions of that Law and its subsidiary legislation include: (i) a uniform, rule-based and less compressed salary structure for all civil servants; (ii) uniform definitions of the types of positions encompassed by the civil service; (iii) establishment of an independent agency, the Agency for Civil Servants, responsible for establishing civil service management policies and procedures, within the limits established by the *Law on Civil Servants*, for overseeing effective implementation of the *Law on Civil Servants*, for maintaining a central civil servants registry for the personnel files for all civil servants, for ensuring effective training of civil servants, and also given a significant role in key civil service management actions (recruitment and selection); (iv) establishment of the courts as the appeals mechanism for civil service management actions. The key challenge now facing both the Agency for Civil Servants and the Government is to effectively implement this Law.

4.17 **Considerable work remains to be undertaken to establish detailed rules, procedures, guidelines and mechanisms to govern public management (management of programs, policies and service delivery; budget management; and human resource management), so as to ensure greater financial and performance accountability**. The number and variety of rules, procedures, guidelines and mechanisms that will need to be carefully reviewed and revised is substantial. This owes both to the fact that all aspects of public management must be addressed (financial management; personnel management; and program, policy and public service management), as well as to the fact that many of the legal instruments governing these are prepared by and apply to individual ministries. The latter factor makes this challenge particularly daunting in FYR Macedonia. To illustrate: each ministry in FYR Macedonia

[88] Within this chapter, "institutions" is defined as shared rules of the game (both formal and informal), shared understandings regarding what sorts of behavior are consistent with those rules of the game and shared proclivities to mutually reinforce compliance with those rules of the game. This definition is intended to be nothing more than a restatement of the definition adopted by one of the pioneers in the literature on institutions, Douglass C. North, who defined institutions as rules, both formal (such as statutes) and informal (such as norms) that constrain behavior (North, Douglass C., "Institutions", *Journal of Economic Perspectives* 5(1): 97-112).
[89] The Law first passed in July 2000 and was subsequently amended in April 2001.
[90] The requirement for a two-thirds parliamentary vote on changes to this law (it is deemed to have constitutional implications) has presented a barrier to the Government's divestment strategy as the majority of proposed divestments require amendments to this law.

prepares, subject to Government approval, and is governed by its own regulations governing its internal organization and activities; its own regulations on the systematization of its tasks and activities; its own "Book of Rules" for wages, allowances and other remuneration; and often, its own collective agreement with one or more labor unions. Under the recently enacted *Law on Civil Servants*, these "Books of Rules" are now subject to the review of the Agency for Civil Servants.

4.18 Given this, the Government will need to take a two-phased approach to addressing this challenge. The first phase will require reviewing and revising all central rules, procedures, guidelines and mechanisms, including in particular the criteria and objectives (both explicit and implicit) employed by Government when it reviews and approves ministry-proposed rules and regulations on the organization and management (O&M) of a given ministry. During the second phase the Government would use the results of the first phase in order to review ministry-specific rules, procedures, guidelines and mechanisms governing O&M within each ministry.

4.19 **The underlying thrust would be to make sure that such rules, procedures and guidelines are designed to foster contestability, in both the formulation and the implementation of policies and programs.** Contestability can be fostered by creating at least six general types of mechanisms: competition requirements, choice-narrowing decision-making arrangements, feedback requirements, oversight mechanisms, "sunset" provisions and redress mechanisms. The means of fostering contestability are summarized in Annex 4.2. An important element of this phase would be elaboration of the detailed legal instruments required for implementation of the *Law on Civil Service.* These would include the rules, regulations, procedures and guidelines governing the preparation of job descriptions, job valuations, salary setting, recruitment and selection, performance evaluations, promotions, disciplinary actions and appeals. All would need to be specified with an eye to ensuring a heavy reliance on contestability mechanisms. Much of this subsidiary legislation is now in place, although some still remains to be completed.

4.20 The second phase would involve applying those revised central regulations, procedures and guidelines, and the criteria upon which they are based, to a review of the O&M regulations, procedures, guidelines and mechanisms of individual ministries. The major ministry-specific instruments to be reviewed would include:

- Personnel management regulations, such as job descriptions, job valuations, recruitment and selection procedures and criteria, performance evaluation procedures and criteria, promotions procedures and criteria, disciplinary procedures and criteria and internal appeals procedures.
- "Books of Rules" for wages, allowances and other remuneration.
- Rules governing internal organization and activities.
- Regulations governing the systematization of tasks and activities.
- Collective agreements with one or more labor unions

Institutional Barriers to Meeting Organizational Objectives

4.21 Not surprisingly, given the incomplete nature of basic legislation, the institutional framework that sets the "rules of the game" is still in the early stages of transformation (see Annex 4.1). At present, no organizational body has explicit responsibility for the development and implementation of human resources policies for personnel outside the civil service. The policy framework, such as it is, is shaped by several administration-wide regulations for human resource management[91] and supplemented to a certain degree by organization-level regulations. On the whole, however, the body of regulations provides piecemeal coverage rather than an integrated system. Compounding this weakness is the fact that FYR Macedonia currently lacks an independent body with a clear mandate and authority to oversee fairness of existing human resource policies and management for personnel beyond the scope of the *Law on Civil Servants.*

4.22 **The general managerial culture in the administration focuses on inputs and compliance with formal regulations rather than on outputs or outcomes and the performance necessary to achieve them.**[92] Decision-making power tends to be concentrated at the top of the hierarchy, with many decisions that might under more devolved systems be made by middle or senior managers being channeled up to ministers or the Cabinet. Although formal emphasis is on compliance with rules (as enforced by the various inspectorates), reports on actual practices are mixed. While on one hand several officials noted that staff are careful to obey rules in order to safeguard their jobs, other reports document how politicization undermines discipline and authority.

4.23 As far as human resources management is concerned, certain standards (such as regulations regarding certain technical aspects of recruitment) are prescribed centrally; compliance with these formal guidelines is reported to be good. However, in practice, management of human resources is largely discretionary and conducted without the guidance of dedicated capacities and specialized skills (for example, only four ministries have formal human resources departments). With some limited exceptions, no formal performance appraisals are conducted. Likewise, the important function of staff planning appears not to be practiced by ministries or other agencies. Each body makes its own hiring decisions, in compliance with the procedural regulations and formally within the bounds of the enumeration of authorized posts but such actions do not appear to be consistently linked to any forward looking staffing strategy. (See Annex 4.2 for additional treatment of management issues). Effective implementation of the *Law on Civil Servants* could address these weaknesses for positions within the coverage of that Law.

4.24 The ramifications of weaknesses in these interlinked systems resonate from the "micro" level of the individual employee through to the aggregate level of the Government's ability to set and achieve strategic policy objectives. In contrast to a coherent, performance-oriented system that marshals resources toward successful implementation of strategic policy priorities, FYR Macedonia's arrangements encourage government employees to focus narrowly on compliance with formal rules and procedures, while generally failing to present employees with robust policy and program objectives, and effectively motivating employees to work towards any such objectives.

4.25 **The flaws in FYR Macedonia's central processes for strategic prioritization have their counterparts at the level of each organization, in the form of weak incentives and**

[91] These are largely contained in the Law on Administrative Bodies and the Labor Code.
[92] For example, Ministry of Justice's Administrative Inspectors monitor implementation of the Law on General Administrative Procedures and related sector-specific regulations (particularly in urban planning and construction). However, the focus is on narrow compliance with procedures and educational requirements for staff, and does not in any way address productivity or similar issues.

ability to set clear strategic objectives of its own. These shortcomings are transferred further down the chain, affecting management and staff. In the absence of effective institutional arrangements for enacting legitimate strategic objectives, the personal objectives – good or bad – of those who, at any given moment, hold power within the public administration unavoidably move in to fill the gap. Where such politicization is evident, in FYR Macedonia as elsewhere, the major dynamic driving employee behavior can easily switch away from performance and toward meeting – or at least not endangering – the personal objectives of politically influential individuals.

4.26 The result of an institutional orientation toward addressing short-term pressures or objectives might, in certain instances, prevent a manager from acting strategically within his or her sector. Effective leadership may prevail over the absence or near absence of systematic institutional pressures to meet institutionally set policy objectives. In general, however, a weak institutional framework can (and often does) allow individuals to focus on furthering their own economic or other interests over those of public policy, and to pursue these goals largely unchecked. The range of problems that might arise is vast, including policy distortions, outright economic infractions, or conflicts of interest such as public officials or their family members owning companies that do business with government. Indeed, such conflicts of interest are in evidence in FYR Macedonia although they are not currently regulated, a fact that further testifies to an institutional framework that is poorly armed to ensure the pursuit of stable organizational, as opposed to personal, objectives.

- Whether the results are good or bad, given the inevitability of political turnover, systems driven by private objectives will exhibit a strong tendency toward fundamental instability. A change in government, a shift in the balance of power within the executive, or the departure of a particular minister or manager may well result in a substantial reorientation in policy, activities and staffing assignments with no guarantee that such changes will further those strategic objectives that do exist, or the public interest. This is of particular relevance to FYR Macedonia, in light of recent World Bank research indicating that FYR Macedonia's executive is highly exposed to the risk of dismissal.[93] Such impacts are intensified given the history of short-lived coalition Governments in FYR Macedonia. In contrast, long-term stability in the pursuit of legitimate strategic objectives is more likely to be facilitated by a robust institutional framework that focuses on and provides incentives for meeting organizational objectives; provides an appropriate balance between autonomy and accountability; and has appropriate provisions for oversight and enforcement. Effective implementation of the *Law on Civil Servants* could help to address these risks.

4.27 It is telling that **FYR Macedonia lacks the most fundamental institutional device to promote and ensure sustained emphasis on performance: a formal performance appraisal system.** Despite some limited independent initiatives by individual organizations[94], the absence of an administration-wide requirement for performance appraisals (which, ideally, would be coupled with oversight mechanisms to ensure the reliability and probity of such performance

[93] "Initial Work on Analyzing and Measuring the Balance of Power Between the Executive and the Legislative", Nick Manning and Naazneen Barma, World Bank, 1999.
[94] The Ministry of Interior has limited appraisals, in the form of monthly performance-related salary increases or decreases.

appraisals) means that there is no structured, reasonably objective basis for providing feedback to staff and rewarding good performers (or punishing poor performers). In addition to implications for day to day staff management, this has broader systemic implications. For example, such appraisal information could be used to better target training among staff with particular performance shortcomings, or alternatively, in the case of employment reductions, to help ensure that individuals with a track record of good performance are retained, thereby protecting the quality of the workforce. Fortunately, with the recent passage of the *Law on Civil Servants* and its subsidiary legislation, policies have been established requiring annual performance appraisals for all civil servants. Effective implementation of the policies and procedures established for those performance appraisals is a key challenge currently facing FYR Macedonia's public administration.

4.28 Related to this, **institutional mechanisms to focus managers or, indeed, organizations as a whole, on whether and how well their units are achieving their policy objectives are also absent**. The policy objectives of programs and organizational units are difficult to ascertain because little exists in the way of systematic mechanisms to ensure agreement on such objectives. Not surprisingly, in the absence of clearly defined organizational and program objectives, performance indicators for departments or organizations are not generally collected.[95] The planned institution of ministry budget plans with priorities, program objectives, and expected results should, over time, ameliorate this situation.

4.29 In the absence of institutional arrangements that focus the administration on agreed policy objectives, it is perhaps not surprising to discover considerable concentration of managerial authority in the hands of top political appointees, such as ministers. This fact compounds the unstable nature of incentives to staff, since accountability tends to be political and personal, rather than organizational. This tendency appears to be exacerbated by weaknesses in institutions aimed at ensuring transparency in the management of personnel. In particular, ministers tend to have a significant degree of discretionary power over staffing decisions, without the transparent processes and performance accountability that would discourage abuse. When these conditions are coupled with considerable political instability (i.e., high risk of frequent changes in top political appointees), it should come as no surprise that ministers tend not to delegate their authority. More specifically, under these circumstances, ministers can be expected to find it in their interest to maintain as thoroughgoing control as possible over the management of their ministry, in order to achieve whatever short-term objectives they might have within the uncertain, but almost certainly short, tenure they are likely to enjoy. Indeed, formal and informal[96] institutions channel power into the minister's hands, while ensuring that below the minister level managers enjoy very little autonomy, both with regard to budgetary discretion and authority to make substantive decisions over staffing or programs. The recently adopted *Law on Civil Servants* and its subsidiary legislation provides a legal framework that is designed to reduce this concentration of managerial authority in the hands of top political appointees, such as ministers, in the management of the civil service. Effective implementation of that new legal framework poses a formidable challenge to both the Agency for Civil Servants and the Government.

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[95] This is the case, for example, in the Agency for Common Services which provides a wide array of services to government bodies but has no formal mechanism for assessing its own performance.

[96] For example, due to pervasive politicization, managers may avoid making any decisions that they perceive as potentially jeopardizing their tenure.

4.30 Such a pattern is problematic relative to the aim of building a set of institutions designed to focus an organization and its staff on achieving stable, organizationally agreed policy objectives. In practice, this pattern tends to overload the minister's office with matters that could otherwise be delegated in order to achieve greater effectiveness and efficiency. Such pairing of accountability with autonomy, however, is far from feasible in FYR Macedonia at this moment. At the same time, a sensible strategy for enhancing both procedural and performance accountability will need to quite explicitly break up the monopoly on managerial authority currently held by top political appointees, such as ministers and heads of autonomous or semi-autonomous public bodies. Concurrently, such a strategy will need to create institutional mechanisms that impose considerable checks on the exercise of such more broadly distributed managerial authority, at least until such time as a reasonable level of procedural and performance accountability are evident. This is precisely what the *Law on Civil Servants* and its subsidiary legislation is capable of doing, if effectively implemented.

Politicization

4.31 A phenomenon closely linked to performance issues is that of politicization. As in other central and east European countries, **one of the most striking features in FYR Macedonia is the extent to which politicization pervades the public administration**. The legislation, regulations and other formal rules remain largely the same as under the socialist regime, with some ad hoc modifications made in the intervening years. As already noted, the new and recently revised Law on Civil Servants lays the groundwork for a professional civil service, but is, as yet, not fully tested as its implementation has only begun.

4.32 While some limited merit-based practices are in place, these are generally inadequate or undermined by the extent to which all types of personnel decisions are ultimately made by ministry heads, which is to say, explicitly political appointees. As noted above, there is little in the way of independent institutional mechanisms to ensure that such personnel actions reflect merit, performance and professional factors. These weaknesses in formal systems are borne out in practice, with numerous reports of overtly political influence on staffing decisions. Again, implementation of the new *Law on Civil Servants* could, if properly undertaken, address this problem within the ranks of the civil service.

4.33 It has been demonstrated that politicization has a detrimental effect on performance, most obviously by fostering an environment of persistent insecurity.[97] Earlier chapters of this report have explored the ability of the central decision-making system to determine and promote strategic priorities for government. The weaknesses highlighted in those chapters both affect and are magnified by the politicization of personnel management institutions. First, weaknesses in the ability to enforce a systemic focus on strategic (over personal) objectives are likely to be accompanied by inadequate incentives to manage and allocate human resources in a manner that is consistent with achieving these objectives. Furthermore, the weaknesses in human resources institutions will themselves feed back into strategic processes, since having a body of appropriately skilled and well-managed professionals is important to the capacity to develop and evaluate sectoral policies.

[97] See *World Bank Development Report*, 1997.

4.34 In FYR Macedonia, institutions don't meet the first requirement of a well-performing administration: focus on stable strategic objectives. A second requirement, procedural accountability, shows a number of weaknesses. These constraints pose major obstacles to depoliticizing FYR Macedonia's public administration and to enhancing the capacity of that administration to actually achieve strategic objectives.

IMPLEMENTING A HUMAN RESOURCES MANAGEMENT FRAMEWORK

4.35 The challenges identified above and in the previous chapters are extraordinarily difficult to overcome. FYR Macedonia's limited resources, both human and financial, pose a fundamental constraint. FYR Macedonia is not in a position, for instance, to significantly upgrade the capacities of its entire public administration within any reasonably short time frame, say, two to three years. The Government will need to focus its efforts on elements of its public administration that are sufficiently circumscribed to permit it to bring enough human and other resources to bear to expect to have some impact. To do this, it will need to sequence its interventions in ways designed to reduce demands on and improve the allocation of its resources first, then build core institutional capacities and strengthen accountability. This will enable the Government ultimately to target resources on high priority policies and programs.

4.36 Actions required to address HRM issues raised in the above analysis may be conveniently grouped into three broad areas: (i) improving pay and employment structures; (ii) establishing the legal, institutional and management framework required to create and maintain a professional, meritocratic, performance-oriented civil service; and (iii) implementing this new human resource management (HRM) framework. We briefly summarize some of the more important actions that the Government would be well advised to consider undertaking within each of these three broad HRM areas.

4.37 **Improve pay and employment structures.**

a) Restructure salaries (decompress so as to ensure more competitive remuneration among key posts)
   i) Round 1:
      (1) Develop proposal for implementing the CS salary scale (i.e., propose the value of a "point", which is the single policy parameter whose value must be set in implementing the salary scale mandated by the CS Law)
      (2) Undertake fiscal impact analysis of this proposal, including identifying employment reductions required to make any given "point" value fiscally feasible (i.e., consistent with the Government's fiscal program, as agreed with the IMF)
      (3) Ensure that each first line budget user develops a time-bound action plan for achieving an agreed set of employment reductions required to allow fiscally feasible implementation of the CS salary scale proposal by the date mandated in the CS Law.
      (4) Make all employment reductions required for fiscally feasible implementation of the CS salary scale proposal.
      (5) Approve and implement new CS salary scale
   ii) Round 2 (1-2 years later, repeating on a regular basis thereafter):

(1) Undertake salary survey

(2) Repeat Round 1, using salary survey results to inform deliberations regarding medium term targets for improving both the level and, possibly, the structure of civil service salaries (the latter would require an amendment to the CS Law).

b) Launch and publish periodic summary reports on employment and remuneration for all first line budget users (and possibly second line budget users as well) from newly established public employment registry in the Ministry of Finance. Reports should identify:

i) Total employment (full time; part time)

ii) Employment by type of position (higher level officials, CS Law categories, other public servants grouped by some consistent categorization, public employees covered by special Acts (e.g., teachers, health care professionals, uniformed services)

iii) Number of employees holding more than one position

iv) Total and average remuneration by type of position (higher level officials, CS Law categories, other public servants grouped by some consistent categorization, public employees covered by special Acts (e.g., teachers, health care professionals, uniformed services). Once salary survey data is available, provide comparisons by type of position with private sector salaries.

v) Quarterly turnover rates by broad position groups (higher level, CS, other public servants, special Acts employees). At a later date, budget-user-specific quarterly turnover rates should be made available and plotted against turnover in political leadership.

4.38 **Establish legal, institutional and management framework required for a professional, meritocratic, performance-oriented civil service.**

(a) Establish capacities of Agency for Civil Servants required for effective implementation of the *Law on Civil Servants*, including but not limited to: specification of a clear mission statement; identification of specific objectives and means by which the Agency's performance in meeting those objectives will be monitored and evaluated; development of procedures and capacities to monitor the Agency's performance in meeting those objectives; establish internal organization of the Agency; identify and fully meet staffing requirements; prepare detailed work-program for the Agency; etc.).

(b) Complete remaining subsidiary legislation (regulations, guidelines, procedures) required to implement *Law on Civil Service* and ensure consistency across budget users in HRM practices and procedures (rules governing preparation of job descriptions, job valuations, performance appraisals, recruitment and selection, promotions, transfers, disciplinary actions, etc.). CS Law and subsidiary legislation should jointly satisfy prerequisites for a professional, meritocratic civil service.[98]

[98] See "Minimum requirements for Macedonia's legal framework to establish the prerequisites for a professional, meritocratic civil service.", Gary J. Reid, World Bank, 1999.

(c) Establish action plan for helping individual budget users to implement this HRM framework (addressing, among other issues, guidelines for organizational structures, strategy for sequentially implementing the CS Law and its subsidiary legislation in each budget user, etc.).

4.39 **Implement this new HRM framework.**

(a) Implement action plan for implementing this HRM framework, beginning with appointment of highest ranking civil servant (e.g., Secretary General) in each first-line budget user, and including, among other things, training in the regulations, guidelines and procedures developed above.

(b) Launch concerted effort to focus budget users on performance objectives (to be linked with budget reform):

(i) Establish guidelines and procedures for defining and reaching agreement on policy objectives for first and second line budget users.

(ii) Prepare and deliver training program aimed at helping budget users to define and reach agreement on their policy objectives and how they will measure, monitor and evaluate the extent to which their units are achieving those objectives and meeting those performance targets.

(iii)Prepare and deliver training program aimed at helping civil servants to define and reach agreement on performance objectives for their work that reflect the policy and program objectives of the unit in which they are employed.

4.40 **Monitor both implementation and impacts of this effort, and publicize results.**

ANNEXES TO CHAPTER 1

ANNEX 1.1

FINANCIAL AND INFRASTRUCTURAL FRAMEWORK FOR ESTABLISHMENT OF THE SECOND PILLAR OF THE PENSION SYSTEM IN FYR MACEDONIA

1. FYR Macedonian Parliament has passed a law in March 2000 to reform the pension system. The law opened a way to (i) progressive changes in the existing PAYG pillar, such as an increase in the retirement age and reduction of the income replacement level, and (ii) establishment of the second pillar, and third pillar at some future point. It is important to have a realistic assessment of the conditions for establishment of the private funded pillars, particularly the second one - mandatory defined-contribution pillar based on pension funds run by private pension managers. The third pillar, although largely mirroring the second pillar, is usually less controversial due to its voluntary nature. Therefore, the second pillar draws the primary focus of the policy makers.

2. This annex provides a broad overview of the conditions required for establishment of the second pillar. The requirements have been proven in related literature on pension systems, and in specific country examples, to be of varying degrees of importance, ranging from low (meaning that funded pension pillars can start without them, e.g., a developed real estate market as the object of pension fund investment) to indispensable (such as at least some sort of supervision of the reformed pension system). This annex compares the existing infrastructure and financial environment in FYR Macedonia with these requirements and assesses what could be an appropriate approach for FYR Macedonian authorities in moving to a multi-pillar pension system.

Conditions for Establishment of the Second Pillar

3. A number of developing countries, most of them in Latin America and among the transition economies[1], have moved, or are in the process of moving, to a multi-pillar pension system following a successful introduction of such a system by Chile in the early 1980's. There is no single recipe for transition from a state-run social security system to a system fully based on private pension funds. More often than not, countries establish a combination of both. Nevertheless, certain uniform conditions are best put in place before a multi-pillar system actually kicks off.

4. Different designs of the private funded pillars require different minimum conditions to be in place for the private pillars to start operating effectively. Designs built on the idea of importing most second pillar services (supervision, asset management, record-keeping, etc.) from abroad may require few pre-requisites to exist in the reforming country, while a design completely based on all services and investment opportunities being provided by local agents

[1] Bolivia, Argentina, Colombia, Mexico, Hungary, Latvia, Kazakhstan, Poland, Croatia, etc.

and local financial markets would require extensive prior work before the private pension funds should be allowed to offer their services to the population. This annex looks at this extended set of conditions.

5. Generally, the conditions can be grouped into several broad areas: (i) political environment, (ii) institutional (legal, technical, and human resources (HR)) infrastructure, (iii) developed financial market offering investment opportunities, and (iv) conducive monetary and fiscal policy (macroeconomic environment). This annex reviews these conditions and assesses their status in FYR Macedonia.

A. POLITICAL ENVIRONMENT

6. Switching to a new pension system is a fundamental social security reform, which requires long-term vision and patience from the authorities and the population throughout the transition period. It is a reform that will affect generations to come. There must, therefore, be a strong commitment across the political spectrum for the reform. More importantly, the society at large, including both the population and the political authorities, must have full ownership of the reforms and a decent understanding about the impact, both positive (usually in the long term) and possibly negative (usually transition-related uncertainty in the short term) that the reform will have on its stakeholders.

Situation in FYR Macedonia

7. FYR Macedonian Parliament has passed the new law on pension insurance in late March 2000. The law envisages the start of the second pillar based on private pension funds in September 2001. This schedule has been delayed due to insufficient preparation and inadequate funding for the transition. A draft law specifying more technical aspects of the transition to the multi-pillar system has been adopted by the Government and is in the process of Parliamentary review. Initial population polls indicate that knowledge of people about the reform and what the new system would bring is mixed. The Worker's Union reacted immediately after the passage of the new law, threatening with general strikes if the reformist provisions of the law are implemented.

8. Dissatisfaction of certain population groups, arising from their sense of uncertainty and loss in the short-term, and their opposition to reforms could and should be expected. What is needed in the next months, prior to the envisaged start of the second pillar (no matter what shape the pillar will take at the start), is a concerted effort by the authorities to educate the population in a very comprehensive and transparent manner about the reform and its impact. This basically implies a change management exercise aimed at educating and preparing the public to accept the change and uncertainty, and development of ownership of the reform. Significant efforts are underway in this area as part of the Bank's Pension Reform Technical Assistance Project.

B. INSTITUTIONAL INFRASTRUCTURE

9. Effective introduction of the second pension system pillar will require numerous elements of the legal, technical, and human resource infrastructure to be in place or at least at an

advanced stage of development. These include, but are not limited to: (i) collection services with fully-established registration of the payees and their payments into the pension system; (ii) adequate risk management/actuarial services; (iii) international accounting, auditing and securities rating standards and services; (iv) custodial services for pension fund assets; (v) a securities registry; (vi) an adequate supervisory framework with clearly defined responsibilities, legal framework for regulation and trained and adequately paid staff (this applies to all aspects of the financial system, including banks, securities, insurance companies, and pension funds); (vii) *adequate corporate governance regulations ensuring proper fiduciary responsibilities of the* pension fund trustees; (viii) adequate telecommunication networks, (ix) adequate payment and securities clearing and settlement systems; and (x) adequate specialist human resources to run both the supervisory structure and the private pension funds.

Situation in FYR Macedonia

10. **Collection and payment systems.** Until the end of 2001, social security contributions were being collected by the principal payment system agent - ZPP. ZPP has been replaced by an RTGS system for large-value payments maintained by the NBRM, a clearing house for other payments performed by the deposit banks, and by the Central Register Organization as the successor of ZPP in continuing the registry functions. The reform, which is also a part of the Bank's FESAL II project, has called for revisions and changes in 20+ laws and regulations.

11. Responsibility for collecting social security payments will rest with the tax administration (Public Revenue Office), including contributions to the newly established second pillar. There will be a centralized collection facility as part of a larger tax collection entity. A registry of individual contributors, including accounting for the flows of contributions, could be performed by a private firm(s). The responsible entities, whichever they happen to be, will have to do extensive preparatory work in designing the system of collecting and distributing the contributions, and in establishing a registry to maintain individual accounts of all contributors to the second pillar.

12. **Human resources.** Domestic human resources, including adequately educated actuaries/risk managers, portfolio managers, pension reform and insurance experts and similar specialists are in short supply. Technical assistance is being provided by the World Bank in the reform area. However, more educational/training assistance will be needed in the near future. A specialized Banking/Financial Institute (provisional name meaning an entity established by a professional association of banks and other financial industry firms for training purposes) could be useful by bringing in trainers to share their expertise in the areas where the know-how is mostly missing, such as risk and portfolio management.

13. **Accounting and auditing standards.** International accounting and auditing standards (IAS) have been formally adopted in FYR Macedonia. However, the IAS version which has been translated and published by the Government as the official code of accounting practices has become outdated soon after publishing. The new set of IAS should be adopted as the national standards, and their enforcement assured through appropriate laws (company, banking, pension fund laws, etc.). This should be complemented by establishment of a self-regulating

organization, which would license local accountants and auditors. This is part of the conditionality of the Bank's FESAL II project.

14. **Custodial services.** FYR Macedonian commercial banks have been maintaining separate non-balance sheet accounts (completely outside on- and off-balance sheet), where assets managed on behalf of their customers are kept. The quality of this practice is uncertain, but in a positive scenario the expertise accumulated through this practice could lead to a relatively smooth adoption by the banks of a role of custodian for the pension funds.

15. **Securities registry.** Macedonian Clearing and Depository Company is to be created with responsibility for registering and record-keeping of ownership of securities, as well as executing securities settlement procedures. The reform allows dematerialized trading and delivery-versus-payment based clearing and settlement of securities and improves corporate governance and investor protection. This reform, like the payment system reform, calls for revision and changes in some 15 laws and regulations.

16. **Supervision.** Establishing adequate supervision of the reformed pension system workings, particularly pension asset management funds, is one of the key aspects of the reform. International experience provides various models of pension fund supervision; e.g., independent entity vs. integrated supervisory body.

17. International consultants are working (as part of the Bank's TA project) on the recommendations for the optimal supervisory structure in FYR Macedonia. Optimally, an integrated financial services regulator could be created at some future point, covering most or all aspects of the financial markets. For the present, the current Macedonian Securities and Exchange Commission (MSEC) is too weak to assume the role of pension funds supervisor. If the authorities decide to create an integrated regulator, enlargement of the weak SEC would not be the most efficient approach. The NBRM, with its reasonably well functioning bank supervision department, would be a better choice to assume pension fund regulation responsibility.

18. There would most likely be a need for further regulations towards the funded pillar workings to be adopted by the supervisory agency. The supervisors would have to promote as a priority a robust corporate governance framework (involving change/s in relevant laws as necessary) whereby the pension fund trustees and managers would be assigned clear accountability for their actions and performance, thus strengthening public trust in the reform. Higher quality of the supervision would be ensured by putting in place twinning arrangements between the local and foreign supervisors.

C. DEVELOPED FINANCIAL MARKET

19. The pension payouts of beneficiaries of defined-contribution pension schemes are highly dependent on the return on investment that the private pension funds generate. Hence, the funds need an adequate number of investment instruments/opportunities and adequate depth of the

financial market in general, in order to diversify the risks of the pension funds while allowing them to generate reasonable returns on the assets entrusted to them.

20. The instruments include, first and foremost, a developed and liquid treasury securities markets, both primary and secondary. Also, there should be a developed and liquid corporate securities market, based on a functioning stock exchange. The banking system must be sound and prudent, and should offer an array of financial services. Also, banks would likely serve as custodians of the pension fund assets, issue certificates of deposit as an investment instrument, and in case of underdeveloped financial system, may be the only agents capable of providing the initial capital to start pension funds. A developed life insurance system and market with appropriate instruments (e.g., annuities) is needed in the longer term as well, in order to facilitate the payout of pensions to beneficiaries. A developed mortgage system and market, offering mortgage-backed securities as an investment opportunity, would further serve to diversify the risks and optimize investment portfolios of the pension funds. Overall, in the ideal scenario, domestic financial sector should have adequate absorption capacity to satisfy investment needs of pension funds, by accommodating gradually increasing private savings accumulated by the funds. Finally, pension funds should have access to investment opportunities abroad.

Situation in FYR Macedonia

21. Much work remains to create financial markets capable of supporting an effective second pillar in FYR Macedonia. An adequate range of local investment opportunities in the FYR Macedonian financial markets is essential.

22. **Treasuries.** Tradable treasury securities-usually among the main investment instruments in the newly reformed pension systems-are absent in FYR Macedonia. The Government is advised to start issuing T-bills, and bonds as appropriate in due course, to develop the primary and secondary markets of these securities and thereby promote the capital market development objective. Government papers would serve to set benchmarks for pricing of private securities, and may be used, at least partially, to finance the transition to a new pension system if part of the T-bills are bought and continuously rolled over by the newly created pension funds.

23. **Corporate bonds & stocks.** Stock market was established in 1995. However, there are just a few blue chip companies listed on the exchange. A listing requirement for companies to show a transparent picture of their financial state, based on appropriate accounting standards, may be among main causes for low listing numbers in an environment where double accounting is thriving. Trading activity is rather low—USD 26.5 million in 1999, a sharp drop from USD 87.5 million in 1998. 1999 and 2000 registered a rebound in trading..

24. There are limited number of bonds placed on the exchange. Stock trading takes place twice a week for a few hours each time. Many deals seem to be made outside the central market and only when there is a direct match of demand and supply of particular stock. This suggests shallowness, illiquidity and underlying volatility of the stock market, where even small investments can move the price of a stock significantly. Relatively larger investments may become frozen due to the absence of demand in a particular stock.

25. Development prospects of the stock market are hampered by (i) the fact that the privatization program is in an advanced state, reducing the potential extent to which state-owned companies, privatized via the exchange, would provide a critical mass of equity and a fresh impetus for continuous market trading, and (ii) general absence of the government at the exchange. High real interest rates and low savings present further obstacles to a fast revival of the stock market. The major source of the stock market development, therefore, is a positive growth of the economy which would attract foreign investments and increase the amount of resources of institutional and individual local investors available for investment. The results of this development will not come fast, and should be expected in a medium- to long-term.

26. **Banks.** The banking system is the most developed part of the financial sector. Nevertheless, except for a few largest banks, the system is fragmented and characterized by small and weak banks providing unsophisticated elementary banking services. The entire system, including the biggest banks, is still burdened by non-performing assets. Entrance into the market by foreign—notably Greek—investors[2] is a welcome development which is expected to facilitate improvement in financial strength, spectrum and quality of services offered by the banks receiving the investments, and to promote faster growth, development, and needed competition (and, hopefully, consolidation) of the overall banking system.

27. **Insurance & real estate.** The insurance market is operational but is yet inadequate to play its part in a multi-pillar pension system. The assumption here is made that insurance companies will serve as the "specialized institutions authorized for pension payments" as provided in the new pension law. Fast development of the insurance system and products is welcome and encouraged for its overall benefits, although specific new instruments, such as annuities which would be required by the reformed pension system setup, may come into need only in the medium-term (10-15 years). The real estate market is in its early infancy. Small investments into rental property might be possible, but it is still a long way to go to see a fully developed market offering a range of investment possibilities, including mortgage-backed securities.

28. **Financial market in general.** Market absorption in FYR Macedonia is highly concentrated in the banking system and is very limited in the rest of the financial system. *The market in general lacks depth and expertise.* The safest and most liquid instruments seem to be NBM certificates of deposit and commercial bank deposits (although the former should not be considered a fully-fledged private investment instrument since the certificates are, first and foremost, an NBM instrument for conducting monetary policy). Deposits and borrowings of the banking system suggest more than adequate absorption capability for the second pillar pension fund assets during the first few years of their operations. However, prudential diversification limits would allow pension fund managers to place only a fraction of the fund assets into commercial banks. Furthermore, it should be kept in mind that there are still a number of weaknesses in the current legal and regulatory framework for banking activity. An ill-designed deposit insurance system further adds to bank deposits being a rather risky investment instrument. The risk is somewhat mitigated by the entrance of foreign strategic investors into the FYR Macedonian banking market, and by progressive reforms in the banking sector, also

[2] In 2000, the Greek Alpha Credit Bank bought 65 percent of Kreditna Banka Skopje, and in March 2000, the National Bank of Greece purchased 65 percent of Stopanska Banka Skopje - the largest FYR Macedonian bank.

including putting the deposit insurance on a sound footing. These policy reforms are incorporated in the FESAL II project.

29. It is somewhat comforting to know that it will take at least two years before pension funds start looking for investment opportunities in the country. FYR Macedonian pension funds, given their initial small size, would be able to find relatively safe, liquid, and attractive investment opportunities in FYR Macedonia and not be forced by prudential considerations to move their entire portfolios abroad if (i) the funds were able to diversify by investing abroad, thus reducing the "burden" of investment on the local market with low absorption capacity, and (ii) capital market developed at high speed prior to the effective start of investment process by the funds. The latter condition is highly doubtful, as it is difficult at present to detect a momentum for speedy development.[3]

D. CONDUCIVE MONETARY AND FISCAL POLICY ENVIRONMENT (INCLUDING TAX ADMINISTRATION)

30. Sound, stable fiscal policy is essential for implementing a multi-pillar pension system. The government should ensure state tax administration is adequately developed and staffed in order to be capable of supporting the new design of social security provision. Monetary policy authorities would have to understand the impact of the introduction of the multi-pillar system on the development of monetary aggregates and the conduct of monetary policy and have necessary measures to address that impact. Maintenance of an open capital account and adequate level of official foreign reserves are needed if pension funds are allowed to invest abroad, and these investments don't put a significant pressure on the exchange rate and monetary stability in general.

Situation in FYR Macedonia

31. **Fiscal Policy.** Fiscal policy of the authorities has been rather prudent in 1996-1999, with general government fiscal deficit not exceeding 1.8 percent of GDP with the exception of 1999 when the regional crisis and a large inflow of refugees pushed the deficit to over 7 percent of GDP. After restoration of fiscal stringency in 2000, the conflict in 2001 has again compromised the deficit target. Initial calculations performed by a working group on the long-term cost and financing of the transition to the multi-pillar system show little serious fiscal obstacles for such transition. As mentioned above, the Government would be well advised to start preparations for issuing government securities without delay. These securities would serve a triple purpose of (i) setting benchmarks for valuation of risk of private securities, (ii) providing an important minimum-risk investment instrument for the pension funds and other investors, and (iii) providing the government with a source of funds to finance, among other items, the transition to the multi-pillar pension system.

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[3] There are examples of countries—e.g., Bolivia and Kazakhstan—with underdeveloped and illiquid capital markets which have reformed their pension systems by establishing second pillars. It should be noted, though, that second pillar assets are mostly (some 80 percent in Bolivia and 95 percent in Kazakhstan) are invested in government securities.

33. **Tax administration.** Office of Public Revenues, assigned with the task of tax administration, has previously been understaffed and lacking tools of work, such as computerized tax registries/databases, and thus incapable of adequately performing its primary functions. The authorities should ensure that the Office is brought up to a level which allows it to perform its duties, including assessment and track-keeping of the contributions to the reformed pension system. It could be added here that tax laws may need to be changed, too, to make them consistent with the provision of the pension reform.

34. **Monetary policy.** The National Bank of Macedonia (NBM) will have to make a careful assessment of the impact of pension fund investments, both local and foreign, on the monetary aggregates and balance of payments. Allowing foreign investments by the pension funds would negatively affect the balance of payments. On the other hand, foreign investments are indispensable in diversifying fund portfolios to an optimal mix of geographical markets based on the markets' absorption capacity, risks, and returns. Furthermore, by current estimates pension funds would collect about 1 percent of GDP, or some USD 25-30 million of premiums a year in the initial stage, with the amount of premiums growing later on. This should be viewed positively in light of gross foreign reserves hovering around 3 to 3.5 months of imports, and the fact that actual foreign investments of the pension funds will not start until 2004 at earliest.

35. From the monetary policy point of view, even a 100 percent investment of the pension fund assets abroad[4] would not seriously compromise the balance of payments position or exert unwanted pressure on the exchange rate. This sets a ground for a fairly liberal approach by policymakers to the limits on foreign investment. Arguments against foreign investments, such as the need to use pension reform to deepen domestic capital market, should be considered with a view in mind that other priorities, e.g., long-term safety of the pension savings, may be more important. Domestic capital market should first of all be advanced by strengthening legal and institutional environment for investments, domestic and foreign alike. The money would follow.

Approach to Establishment of the Second Pillar

36. FYR Macedonia has made a bold step towards the pension system reform by adopting changes and additions to the Law on Pension and Disability Insurance. The amended law gives the authorities time to make all necessary arrangements for the private pension funds to start effectively operating. Given the existing state of the institutional and financial infrastructure, such period is very tight. It is tightened further by the fact that the entire system will have to be tested at least minimally before enacting it. The testing will be needed to make sure the final product - especially the second pillar which is enforced on the society - meets the tough criteria for confidence of the population at large. It would be a mistake to push this reform without testing its workings, as likely failures would diminish population's confidence and ownership in it - two ingredients badly needed for the success of the reform.

37. The authorities are determined to start collecting contributions from the new labor market entrants and the "converts" (existing labor market participants who would use the option to move to the new system) even before all ingredients of the fully functioning funded multi-pillar

[4] Option which was allowed in Estonia which, like FYR Macedonia, doesn't have government securities.

pension system are in place. From the public confidence point of view, that may not be the best option of the FYR Macedonian authorities as the public may get confused if, for instance, there are no private pension fund managers at the time the law is implemented, but the contributions are already being directed to the second pillar. On the other hand, such determination is justified by the need to move decisively to the new system. Experience from countries which have implemented similar reform indicates that reform of the pension system does not necessarily have to wait for a full set of conditions to be in place. A multi-pillar system, if appropriately designed, initiated, and supervised, can precede and even speed up some of the financial and infrastructural developments. As a word of caution, one must keep in mind that despite some positive aspects, such as relatively small group of existing pensioners, FYR Macedonia is starting its pension reform more from a position of weakness rather than strength[5].

38. Given the existing conditions of the infrastructure and financial market, and expected extent of their development (keeping in mind the ongoing financial market reforms and numerous laws and regulations which will have to go through reviews and changes), the best option for FYR Macedonia seems to be:

- to allow fairly liberal international diversification of the pension assets in order to ensure safety and liquidity of these assets from day one,
- allow wide ranges of maximum investment limits of the pension funds, thus providing the supervisors with discretion and flexibility to set the most appropriate targets on different investment classes in the early months/years of the reformed system, and
- to resort to the extent possible to international tenders for pension asset managers in the initial stage.

39. International diversification and wide ranges of investment limits would take care of the limitations of domestic market, including inadequate liquidity and absorption. Foreign managers would bring with them the established expertise and supervision from their domicile countries and set the learning ground for development of local skills in pension management.

[5] One can think of the position of strength in Chile whose financial markets had functioned well for decades; or Hungary and Poland, whose financial markets at the time of reform were much further advanced than FYR Macedonia's are today.

ANNEX 1.2. MACROECONOMIC ASSUMPTIONS BEHIND THE PROJECTIONS OF THE FISCAL ACCOUNTS

1. The fiscal projections presented in Chapter 1 were prepared using the World Bank's Revised Minimum Standard Model (RMSM-X). The model is simple in construction but can be used to analyze the macroeconomic impact of policies under different scenarios. It provides a consistency framework in which basic macroeconomic accounting relationships of a country's national accounts, balance of payments, fiscal accounts, and monetary accounts hold at all times. These accounts are sectors of the model which are inter-linked by variables appearing in more than one account. For example, exports of goods and services appear in both the definition of gross domestic product (GDP) and in the balance of payments. So if, say, exports increase and all other factors remain the same both GDP and the current account balance will increase. In addition, the model allows for feedback effects in which, for example, an increase in GDP affects the current account via changes in import demand. In addition, all sectors are linked via the balance of payments to the model's external debt module used to project the stocks and flows of foreign debt.

2. Results are driven by a set of assumptions in all sectors. These include assumptions regarding GDP growth, price elasticities, demand elasticities, inflation, exchange rate policy, interest rates, capital flows, tax collection, credit growth, and others. The model is thus flexible enough to permit an analysis of the macroeconomic impact of a wide variety of policy options. Changes in any assumption reverberate throughout the model via adjustments in the variables linking the four accounts. For example, a change in the projected growth rate of GDP in any given year will affect import demand and the stock of international reserves at the central bank. This feeds through to the monetary sector via changes in net foreign liabilities and affects the fiscal accounts via higher personal income tax revenue and import duties.

3. The following are the major assumptions underlying the projections in Chapter 1:

- **Macroeconomic framework.** It is assumed that, given the appropriate economic policies and institutional framework, the economy could move toward growth at an annual rate of 6 percent over the next 5 years. It is assumed that the Government maintains monetary discipline in the context of the current exchange rate anchor. Under this scenario, the rate of inflation could be kept at 2 percent per annum in the medium-term, and the current account deficit could be reduced from near 13 percent in 2001 to around 5 percent in 2005. With the reforms in place and robust growth, the external debt burden, which is currently moderate, would come down slowly as non-debt creating sources of external financing would gradually assume a larger role.
- **Aggregate revenue**. Revenue projections are based on two assumptions. One concerns the impact of the VAT. It is assumed that the VAT raises the share of revenue in GDP through 2002. After 2002, the revenues are projected on the assumption that the elasticity between revenue and nominal GDP is equal to one.

- **Expenditure**. The basis for the expenditure projections is the set of reforms recommended in the chapters of the PEIR. The fiscal implications of these recommendations are described in Chapter 1. Table 1.6 of that chapter lists all the expenditure categories that are directly affected and shows the evolution of spending.

4. The following additional assumptions underlie the projections:

- Repayment of the frozen foreign currency accounts commenced in 2000. As of December 1999, the stock of deposits totaled DM 1.098 billion. In 2000, all small depositors with accounts up Euro 50 were fully repaid, and 3 percent of the remaining stock of accounts was repaid. (In 2000, the Government paid the equivalent of 0.8 percent of GDP in interest and principal). The rest was converted into a 10 year bond with two year's grace paying two percent interest. Beginning in 2002, payments of 1.3 percent of GDP will fall due annually.
- The bonds issued in 1999 to recapitalize Stopanska Banka totalled DM 235 million. They have a 15-year maturity with one-year's grace and pay Euribor plus 1 percent. In 2000, the Government paid MKD 382 million, and payment in 2001-02 are projected at about MKD 300 million. Direct subsidies, which have already been cut dramatically, are assumed to disappear altogether.
- Projections of capital expenditures are based on the assumption that current levels are sub-optimal and should be increased gradually to the levels in other transition economies of Central Europe, particularly those of the advanced-reform countries such as Hungary and the Czech Republic (which averaged investment of 6 percent of GDP in 1998).
- As in the case of capital expenditure, much-needed spending on operations and maintenance rises gradually.
- In this scenario, foreign interest payments reflect the payments projected by the central bank based on current obligations, plus any adjustments due to new lending. It is assumed that the volume of foreign borrowing in the next five years is similar to the amounts in recent years. However, it is assumed that there is a gradual shift in composition towards private credit at commercial rates of interest. Domestic interest payments are assumed to remain constant as a share of GDP.
- The category "other" is a residual. In this analysis, the level of revenues and a sustainable deficit are determined first. The difference between them is the sustainable amount of expenditure. In turn, "other" is the difference between this amount and the expenditure on all the items listed in this annex and in the main text.

5. **Deficit.** Deficit projections are based on an analysis of fiscal sustainability. A simple model was constructed to determine what deficit levels would be consistent with the macroeconomic framework outlined above. This was found to be in the order of 1 to 1.5 percent of GDP. In the fiscal projections, the deficit is kept at 1.0 percent of GDP in the medium-term.

ANNEXES TO CHAPTER 2

ANNEX 2.1: POLITICAL INSTITUTIONS AND CENTRAL AGENCIES

A. POLITICAL INSTITUTIONS

Background

1. The Macedonian Constitution stipulates that state powers will be divided among the executive, legislative, and judicial branches. FYR Macedonia has a joint executive comprising the head of state (President) and head of government (Prime Minister). The Constitution acknowledges that executive power is vested in the Government of FYR Macedonia.[6] The President nominates the Prime Minister-designate to form the government following the election, but his ongoing executive role is limited to matters affecting his responsibilities as commander-in-chief of the armed forces or chair of the National Security Council.

2. FYR Macedonia has a complex party system with 32 registered political parties. These include both ideological, ethnic, and religion-based parties.[7] The party system extends to presidential and local elections. The President is directly elected to a five-year term (twice maximum). Presidential candidates are drawn from the major political parties and may represent either a coalition or a single party[8].

3. The FYR Macedonian parliament contains 120 seats, 85 of which represent single constituencies, while 35 are filled by proportional representation. Elections are held every four years. Following the election, the Parliament must be convened within 20 days. Within 10 days of the constitutive meeting of Parliament, the President must appoint a member of the winning party (the Prime Minister-designate) to form a government. The ensuing negotiations must be completed within 20 days at which time the PM-designate proposes the government to Parliament for ratification.

4. Twenty or more members of Parliament can initiate a non-confidence motion in the government. The government must resign if an absolute majority approves the motion—this happened in 1991. If the motion is defeated, another cannot be introduced for 90 days. During the government's term, the Prime Minister can propose the dismissal of ministers but all dismissals have to be ratified by Parliament.

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[6] In FYR Macedonia, the term "the government," rather than cabinet or council of ministers, refers to the executive body of ministers headed by the prime minister. The administrative body serving the government is referred to as the "government office," rather than cabinet office or the chancellery. [Rule Book of Operation of the Government of the Republic of Macedonia].

[7] Separate registered parties exist representing Albanians, Serbs, Turks, Romanies, and Egyptians. There is also an Islamic Way Party for Democratic Action.

[8] In the most recent elections, completed in November 1999, each of the three parties from the ruling coalition ran separate candidates with the candidate from the leading coalition partner [Democratic Party for Macedonian National Unity] gaining the most votes. After settling the dispute over irregularities of the votes, B. Trajkovski replaced K. Gligorov who had served the maximum two terms.

5. Although a detailed government program is presented to the Parliament shortly after government formation, there is no tradition as yet in FYR Macedonia where detailed party platforms or manifestos are presented to the public during the campaign. From a policy reliability perspective, two issues arise. On the one hand, detailed campaign platforms support policy reliability and public accountability since voters theoretically know what they are getting. On the other hand, fiscally unsustainable political commitments will complicate later efforts to develop an affordable government program. In many developed countries, economic, revenue and expenditure projections, along with the estimated cost of each policy proposal, are included in the campaign document. The poor quality of financial analysis in FYR Macedonia, discussed later in this report, suggests that this problem will recur at the political level. Accordingly, efforts to strengthen the government's fiscal capacity may ultimately contribute to the production of more fiscally sound campaign platforms.

6. Upon independence in 1991, the so-called "experts government." without representation from any political party, was formed. However, it was defeated shortly thereafter through a vote of no-confidence. Since then, all governments in FYR Macedonia have been coalitions. Between 1992 and 98, the Social Democratic League of Macedonia [SDSM] headed the ruling coalition. The initial government coalition, led by Prime Minister L. Georgievski of the Democratic Party for Macedonian National Unity [VRMO], was formed in Fall 1998 with 73 of the 120 seats. Interestingly, the VRMO had boycotted the 1994 elections. This coalition was created when the Democratic Party of Albanians joined with the winning coalition (59 seats) to ensure majority representation in the Parliament. The Liberal Democratic Party briefly participated in the coalition but withdrew prior to the presidential elections. Following the recent crisis, a "grand coalition" was formed on May 13, 2001 with over two-thirds of the Parliament, enough to make the constitutional changes required to implement the Framework Agreement.

Executive Branch Structure

7. The division of powers within the FYR Macedonian executive concentrates central decision-making authority in the government. The 1998 government structure included the Prime Minister, Deputy Prime Ministers and 21 ministers with portfolio (see **Table 2A.2**).

Table 2A.1 November 1998 Election Results

Party	No. Seats [120]
Democratic Party for Macedonian National Unity [VRMO]	49*
Democratic Alternative [DA]	13*
Social Democratic League of Macedonia [SDSM]	27
Democratic Prosperity of Albanians in Macedonia [PDP]	14
Democratic Party of Albanians [PDPA]	11*
Other Parties	6

* members of current ruling coalition

TABLE 2A.2 : MINISTRIES IN THE FYR MACEDONIAN GOVERNMENT - 1998		
▪ Agriculture, Forestry & Water Management ▪ Culture ▪ Defence ▪ Development ▪ Economy ▪ Education ▪ Environment	▪ Finance ▪ Foreign Affairs ▪ Health ▪ Immigration ▪ Information ▪ Internal Affairs ▪ Justice ▪ Labour & Social Policy	▪ Local Self-Government ▪ Science ▪ Trade ▪ Transport & Communications ▪ Urban Planning & Construction ▪ Youth & Sports

8. The executive has since been restructured to include a more manageable number of ministries (see **Table 2A.3**).

TABLE 2A.3 : MINISTRIES IN THE FYR MACEDONIAN GOVERNMENT - 2001		
▪ Agriculture, Forestry & Water Management ▪ Culture ▪ Defence ▪ Economy ▪ Education & Science	▪ Environment & Planning ▪ Finance ▪ Foreign Affairs ▪ Health ▪ Internal Affairs	▪ Justice ▪ Labour & Social Policy ▪ Local Self-Government ▪ Transport & Communications

9. With 14 ministries, FYR Macedonia now approximates the size of other governments in central and eastern Europe. By comparison, Bulgaria has 13 ministries, Czech Republic 19, Estonia 14, Hungary 16, Latvia, 12, Lithuania 7, Slovakia 15, Slovenia 16, and Romania 19.[9]

10. The focal point for decision-making is the weekly government meeting, attended by all ministers and senior officials from the General Secretariat. To support the government, FYR Macedonia traditionally used an extensive government committee system comprising standing committees, special committees, and ad hoc working groups. With the adoption of the Government Rules of Procedure in 2001, the government committee system was streamlined. Both the 1998 and 2001 configurations are set out below (see Table 4).

[9] Drawn from the SIGMA Public Management and Centre of Government Profiles.

Table 2A.4 Government Committee Structure - 1998

Standing - 1998	**Special - 1998**
▪ Economic System, Sustainable Development & Current Economic Policy ▪ Foreign Affairs, National Defence & Security ▪ Human Resources & their Development ▪ Personnel ▪ Political System	▪ Euro-Atlantic Integration ▪ Housing Affairs ▪ Immigration Affairs ▪ Planned Production ▪ Privatisation ▪ Rehabilitation of the Banking System
Standing - 2001	**Special - 2001**
▪ Economic System, Current Policy & Human Resources ▪ Political System	▪ Appointments ▪ Euro-Atlantic Integration ▪ Housing & Emigration ▪ Privatisation ▪ Production for Special Purposes

11. As President of the Government, the Prime Minister enjoys the pre-eminent role in the decision-making process. This authority is both explicit and implicit. The Prime Minister is well-positioned to play the lead role in producing a collective commitment within the government to binding policy outcomes. The Prime Minister also retains considerable formal and informal authority. Article 4 of The *Rules and Procedures of the Operation of the Government of Macedonia* sets out the Prime Minister's formal powers. Those include: overseeing the development of the government's annual program; approving the agenda for, convening and chairing government meetings; formulating the government's decisions; coordinating multi-ministry issues; and ensuring the implementation of the government program. The Prime Minister also enjoys considerable informal authority. All major government decisions are routed through the government meeting, including all recommendations from the standing and special committees. Final decisions are made by consensus. Where consensus is difficult, the Prime Minister's perspective generally determines the outcome. The Prime Minister also has the power to nominate and dismiss ministers, subject to parliamentary ratification. Ministerial shuffles in FYR Macedonia have been common, although these invariably involve the party executives of coalition partners as government composition is a key element of the coalition agreement. Purportedly, the relative success of the coalition parties in the presidential and municipal elections influences changes to government composition during the government's mandate.

Legislative Branch: Structure and Roles

12. FYR Macedonia has a unicameral parliament.[10] All draft government legislation is approved by the government before submission to Parliament. Legislation can also be introduced by members of Parliament [MPs] or by groups of at least 10,000 citizens. The annual state budget is presented as a law to Parliament. Although Parliament can amend the budget, it must identify offsets for any additional spending.

13. In Parliament, a law is subject to a two-phase review by parliamentary committees Once passed by Parliament, laws proceed to the President for signature. If the President refuses to sign (cannot refuse where there is a two-thirds vote in favor), the law must be returned to Parliament along with the reasons for refusal. This power is used rarely—in 1998-99, the President used the suspensive veto on four occasions, with Parliament agreeing once and compromising once. If Parliament again supports the law, the President must sign.

14. There are 24 parliamentary committees (see **Table 2A.5)**. They consider laws and follow the implementation of those laws within their mandates. External (non-voting) members may participate as long at the total number does not exceed one-third of the number of MPs. Interestingly, although the number of ministries contracted to 14, the number of parliamentary committees remained the same, and is largely modeled on the former ministry structure. The number of committees appears large when compared to other countries in central and eastern Europe. There are 13 parliamentary committees in the Czech Republic, 10 in Estonia, 16 in Latvia, 22 in Hungary, 18 in Slovakia, and 12 in Slovenia. Committee consolidation to mirror the new ministry structure should be explored as a means of improving inter-sectoral policy coordination (e.g., is it necessary to have separate committees for economy, economic policy and development?).

TABLE 2A.5 : PARLIAMENTARY COMMITTEES	
▪ Agriculture, Forestry & Water Resources Management ▪ Constitutional Issues ▪ Construction & Urban Planning ▪ Culture ▪ Economy ▪ Economic Policy & Development ▪ Education & Science ▪ Election & Appointment Issues ▪ Environment, Youth & Sport ▪ Euro-Atlantic Integration ▪ Finances & Budget Committee ▪ Foreign Policy ▪ Health Care ▪ Inter-Ethnic Relations	▪ Internal Policy & Defence ▪ Labour & Social Policy ▪ Legislative ▪ Marking Anniversaries of Important Events & People ▪ Monetary & Credit Policy & Banking ▪ Political System ▪ Rules of Procedure & Mandatory Immunity Issues ▪ Standing Inquiry for Protection of Civil Freedoms and Rights ▪ Supervising the Work of the Security and Counter-Intelligence Directorate & Intelligence Agency ▪ Traffic & Communication

[10]Key functions include: (i) approving the government and government program; (ii) passing laws; (iii) monitoring the performance of the executive branch; and (iv) ensuring that the executive branch retains the confidence of parliament.

15. The Finance and Budget committee plays two key roles. It is the primary committee for reviewing the budget and it reviews the financial implications of individual laws. With respect to assessing the financial implications of new laws, the committee relies on the financial statement provided by the government that accompanies the draft law. The government recently introduced mandatory fiscal impact analysis for all proposals proceeding for consideration at its meeting. Previously, the sponsoring ministry typically identified that there were no financial impacts to their proposed legislation.

Structural Constraints of FYR Macedonia's Political Institutions

16. The following analysis was prepared before the recent crisis. Unquestionably, the process by which the Framework Agreement was developed and is proceeding towards implementation introduces some non-governmental players into the national decision-making process: the President has assumed a more prominent role, as have the Albanian party executives, and representatives of the international community (NATO, European Union, OSCE). Nonetheless, it can certainly be argued that the importance of the government as an integrating mechanism has been validated as considerable efforts have been made to ensure that it can function as a representative body.

17. Two major elements of the Bank's evaluation framework cut across the institutions described above: (i) whether the model of government is conducive to collective decision-making; and (ii) whether the incentive structure promotes binding, collective policy outcomes.

18. Why should the model of government matter? Bank research suggests that the cabinet model is the most likely to produce and sustain reliable policy outcomes.[11] The likelihood of strong cabinet or cabinet-like governments relates closely to the institutional risk faced; i.e., the greater the threat that government might be defeated or have its major programs altered by Parliament, the greater the likelihood that cabinet-style government will be the system of choice.[12]

19. The underlying rationale is that the cabinet model can better represent the diverse interests of the legislature in the executive's policy deliberations. The incentive for ministers to play this bridging role increases with the likelihood that the legislature will dismiss or undermine the government.[13] Coalition governments, in particular, are vulnerable to the risk of collapse and require a collective forum where all party viewpoints can be expressed and concerted efforts at resolving coalition-threatening issues can be made. When serious disagreements arise, party executives will become involved, but Cabinet must still ratify the ultimate decision.

20. Applying the analytic framework to FYR Macedonia places it among those nations with one of the strongest predisposition for cabinet government. In fact, FYR Macedonia's model of government, that promotes a strong cabinet system in response to institutional risk, is conducive to supporting policy reliability. The government is approved by parliament and both its program

[11] J. Blondel & N. Manning; Why Should Ministers do what they Say? Full and Partial Cabinet Decision-Making Structures in Government; paper produced for the World Bank; 1999.
[12] Manning, N.; Strategic Decision-Making in Cabinet Government; op. cit.
[13] This dynamic breaks down when the level of risk is such that the government is virtually unprotected from dismissal (e.g., Ukraine).

and annual budgets require parliamentary approval. Confidence motions can be brought by 20 MPs which, if successful, require the government's resignation. Parliament has the authority to amend the budget as long as offsets are identified. Like numerous European systems (e.g., Denmark, Estonia, Belgium), the strong likelihood of coalition government increases the risk of dismissal or defeat of a major program.

21. To sustain commitment to collective decision-making, ministers must view membership in and attendance at cabinet as their exclusive gateway to executive decision-making power. If major policy decisions are made in alternative forums, the incentive for ministers to use cabinet as the vehicle for pursuing their policy initiatives is correspondingly reduced. At an individual level, an incentive structure where the head of the government can reward or sanction ministers based on their willingness to support collective decisions further encourages cabinet cohesion. A third level relates to incentives created as a result of the public's expectation of collective government.

22. Common alternative decision-making forums include the president, parliament, party executives, ministerial committees, extra-budgetary public sector organizations, and international organizations.

- In FYR Macedonia, the President does not normally have any specific powers with respect to the central decision-making process, although the recent crisis has obviously increased the President's presence and role regarding the peace negotiations.
- To the degree that legislation generated by MPs addresses significant policy issues, Cabinet's role as the exclusive executive decision-making forum is reduced. In FYR Macedonia from 1991-1998, 96 percent of the approved laws were proposed by the Government [14] (similar to Czech Republic, Hungary).
- Although party executives play an important role in FYR Macedonia, similar to other countries where coalition governments are common (e.g., Bulgaria), they have no independent decision-making authority. If cabinet is working effectively as a brokering forum, the need to revert to party summits should be by exception. FYR Macedonia's coalitions have not been stable in terms of membership, but elections have not been forced owing to coalition collapse.[15] However, the recent crisis has elevated the role played by the Albanian party executives.
- The large majority of cabinet governments use committee systems as a prior step to the cabinet meeting. These committees serve to ensure that cabinet's workload remains manageable and that sufficient time is provided for discussion of strategic and political issues. In FYR Macedonia, like most cabinet systems, all committee recommendations must be ratified at the government meeting.[16]
- There are four key sectors in which extra-budgetary organizations exist: health, pensions, employment, roads. Although the government retains legislative

[14] Figures provided by Deputy Secretary of Parliament: 44 of 1,054 laws passed since 1991 were originated by MPs.
[15] The 1991 "government of experts", which did collapse, was not a formal coalition comprised of political parties
[16] By contrast, Britain's cabinet committee decisions can be finalized without cabinet ratification. Here, the maintenance of cabinet cohesion depends on the ability of cabinet office to ensure that the Prime Minister's views are taken into account and that any minister with a substantive interest in the issue is involved in the committee.

authority over these sectors, greater policy latitude resides in these organizations than would in a ministry agency.

23. Overall, the FYR Macedonian government is recognized and serves as the pre-eminent decision-making body for public policy decisions. Current deliberations on the Framework Agreement aside, no significant alternative forum exists and the internal incentive structure strongly favors collective accountability. At an individual level, the FYR Macedonian Prime Minister is able to provide incentives for cohesive collective behavior as ministers can and have been shuffled. Accordingly, major constraints do not exist at either the collective or individual level. The third area, the public's perception concerning the government's adherence to the tradition of collective cabinet government, is cited as a risk that induces adherence to collective behavior.[17] The importance of coalition government and collective decision-making was identified as being critical to addressing issues relating to FYR Macedonia's ethnic communities, an observation that is assuming increasing importance.

B. CENTRAL AGENCIES

The General Secretariat

24. With the approval of the new *Rules and Procedures* in 2001, the General Secretariat assumed a stronger role with respect to coordinating and managing the Government's policy agenda. The General Secretary plays several roles:

- Coordinates the work of the state secretaries with respect to the preparation of material for review by government or its committees;
- Manages the General Secretariat and provides direction to the expert agencies that report to the government;
- Participates in the government committees;
- On delegation from the Prime Minister, prepares the agenda for government meetings;
- Ensures the material for the meetings is received, checked for legality, appropriate inter-ministerial review, and fiscal impact, and distributed;
- Prepares the minutes from the meeting and distributes the decisions; and
- Coordinates the development of and monitors implementation of the government program.

25. The systematization of the General Secretariat was concluded with the Civil Service Agency in 2001. It includes the following sections:

- General Secretariat, including the Secretary General (12 positions);
- Office of the President of Government (16 positions);
- Studies/Analysis and Expert Matters (5 positions);
- Organization and Legal Matters related to Government Meetings (7 positions);

[17] N. Manning, Strategic Decision-Making in Cabinet Government; op. cit.

- Administrative and Personnel Matters (23 positions);
- Public Relations (6 positions);
- European Integration (8 positions).

26. The majority of staff (estimated 60-70percent) have higher education. In addition to those in the legal secretariat, there are a high number of lawyers among the expert advisers. Although the General Secretariat is viewed as an elite organization, there is little career movement between the Secretariat and line ministries. With the implementation of the Civil Service Law, it is possible that increased career mobility may result.

27. A separate Legal Secretariat exists with 14 staff, including 12 lawyers, reporting to the Government.

The Ministry of Finance[18]

28. The Ministry of Finance (excluding incorporated autonomous bodies such as the Office of Public Revenue, Office of Customs etc. and local units) has undergone significant changes in the last two years. Since his appointment in December 1999, the new Minister of Finance has begun to staff the ministry along the lines recommended by the World Bank.

29. The Department of Budget and Funds, responsible for all stages of the state budget, was staffed by a total of 11 out of 35 authorized posts at the end of 1999. The departmental divisions were staffed as follows:

- The Division of Preparation of the Budget (one person out of 5);
- The Division of the Treasury System (three persons out of 6);
- The Division of Control (one person out of 10);
- The Division of Budget Accounting (two persons out of 4);
- The Division of Macroeconomic Planning and Analysis (three persons out of 4).

30. Since that time, particular emphasis has been placed on increasing the staff in the Budget Preparation and Treasury System Divisions, which are now staffed by more than 25 and 35 staff respectively. Staffing in the Internal Audit Section within the Budget Division has increased to 4 and is targeted for 10. With the streamlining of ministries in 2000, the Ministry of Development's macroeconomic forecasting and capital planning functions were transferred to the Ministry of Finance.

31. In practice, it seems that organizational responsibility is not clearly designated and responsibilities overlap between divisions. Staff are frequently called upon to perform tasks which are nominally the responsibility of staff in another division. The basis for this assignment of responsibility seems to be the size of the task in hand and whoever is available. To address these and other management issues, the ministry has undertaken an internal organizational effectiveness initiative, to be completed in 2001.

[18] Part of this information was provided by the EU-PHARE TA Report (April 99)

ANNEX 2.2

BUDGET INSTITUTIONS IN FYR MACEDONIA : BACKGROUND INFORMATION

1. The legal status of all institutions in the administration is defined by the Law on administrative bodies and by separate sector, systemic laws. None of these statuses are determined in the constitution. All ministries are accountable to the Cabinet, while the off-budgetary funds are accountable to the parent ministries (Ministry of Labor for the Pension and Employment Funds, Ministry of Health for the Health Fund, Ministry of Transport for the Road Fund). The Cabinet appoints and dismisses the Board of Management of the funds. The two agencies (Privatization and BRA) [19] due to their specific status defined under separate laws are also directly accountable to the Cabinet for their operations. Cabinet is also responsible for appointing and dismissing their management.

2. Funding provided by the central budget varies between the ministries. The core ministries[20] are largely budget dependent, 89 percent of their total funding comes from the budget, while the remaining 11 percent come from their own revenues. The funding structure is almost similar for the Defense and Interior ministries while the situation differs quite a lot for the sector ministries[21]. The latter are significant revenue earners with 26 percent of own revenues in total domestic funding, while the rest of 74 percent comes from the central budget. Almost 92 percent of the total domestic funding of the nine sector ministries goes to only four sector ministries (education, sport and youth, science, culture). Those are the ministries that have a wide network of second line users. They also earn 80 percent of the total own revenues earned by all nine sector ministries. The high share of their own revenues gives to these four sector ministries higher autonomy in terms of the spending compared to the rest of the ministries since there are no restrictions for the use of their own revenues. The own revenues could be used for any purpose, the ministries could pay wages, goods and services, could also make investments. The other first line users[22] appear as a significant revenue earner also with 22 percent of the total revenues earned from own revenues.

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[19] The Privatisation Agency (PA) was established in 1993. It is an independent legal entity managed by a Board of Management and the Director which are appointed by the Cabinet. PA performs activities related to the organisation and control of enterprises privatisation. The enterprises are obliged to prepare their own privatisation plans, however in cases where they do not follow the determined deadlines, Privatisation Agency can initiate and take charge of the privatisation procedures following the deadlines defined in the Law on Privatisation. Submits once a year annual report to the Parliament and twice a year to the Cabinet. Bank Rehabilitation Agency (BRA) was established in December 1994, became operational in May following year. It is a legal entity managed by a Board of Management appointed and dismissed by the Cabinet. Reports annually to the Cabinet. It was specifically established to assume, at nominal value, the denar denominated bad loan portfolio of Stopanska Banka in 1995. The BRA also assumed responsibility for the non-performing foreign currency debts of socially-owned and state-owned enterprises to Paris and London/Zurich Club creditors as well as those to the Word Bank, the European Investment Bank, the International Finance Corporation and the EBRD.

[20] Core ministries are Finance, Development, Justice, Economy, Foreign Affairs, Immigration, Information, Labor, Trade, Local government. Defense and Interior are separately treated.

[21] Sector ministries are Health, Education, Culture, Agriculture, Environment, Science, Transport, Urbanism, Sport and Youth.

[22] Other first line users: institutions with coding from 20001 to 38009 include judiciary institutions (courts, prisons), Statistics office, Academy of science etc.

3. As for the off-budgetary funds, two are financed exclusively through earmarked contributions, Health and Pension Fund since the transfers from the central budget to these funds amount to 1.4 and 20 percent, respectively. The transfers from other off-budgetary funds are significant for the Health Fund (32 percent of its total revenues), while in the Pension Fund those transfers are only 5 percent of its total revenues. There are small transfers (5 percent) in the Pension Fund from the Employment Fund. The Pension Fund is the only off-budgetary fund that holds assets in terms of shares acquired through the privatization process. The revenues from sale of part of the owned shares by the Pension Fund amounted to only 3 percent of its total revenues in 1998. Thus, in terms of funding it seems that the Health and the Pension Fund are more independent from the line ministries to which they are accountable. The financing also provides them bigger independence compared to the other two off-budgetary funds Employment and Road Fund, which receive much bigger transfers from the central budget 73.5 and 40 percent, respectively.

4. The two agencies - Privatization and Bank Rehabilitation are not budget users at all. Their specific role provides them revenues enough to cover their operating costs and according to the legislation they are obliged to transfer the excess revenues to the central budget. In 1998, the BRA has paid 860 million denars in the budget while the Privatization Agency paid 70 million denars as proceeds from the sale of state capital.

5. **Disposal of Assets.** None of the ministries and other first line users can sell state assets. However, some of the ministries and other first line users earn own revenues. If they have purchased assets from their own revenues, than they could freely sell them. They could even sell state assets but only depreciated and written-off assets. It is impossible to estimate the magnitude of the sale of these assets. It is certain that depreciated assets sale has negligible magnitude, while it is impossible to estimate what could be the magnitude of the sale of own assets by the ministries.

6. **Financial Reporting.** According to the Law on Budget all ministries and the off-budgetary funds prepare and must submit their annual financial statement to the Ministry of Finance which subsequently aggregates them and prepares a summary financial statement which is submitted to the Government and Parliament for adoption. The aggregated financial statement of the budget is annually published in the Official Gazette. The four off-budget funds are also obliged to submit their financial statements to the Ministry of Finance and they also prepare an annual report that is submitted to the Government for adoption. The reporting mechanism for the two agencies Privatization and Bank Rehabilitation differs from the mechanism that applies to the ministries and off-budgetary funds. They also have to prepare their annual financial statements and submit them to the Cabinet with a notification sent to the Ministry of Finance as well.

Table 2.3A.1 Legal and Funding status and Financial Reporting Requirements for Main Government Budget Institutions

	Ministries, Funds and agencies									
	Indistinguishable from the State				Separate legislative existence					
	Core ministries (1)	Defense Interior	Sector ministries (1)	Other 1rst line users (1)	Health fund	Pension fund	Employment fund	Road fund	Privatization agency	Rehabilitation Agency
DOMESTIC FUNDING (bln denars)										
Main budget (2) as a percent of total funding	3,581 (89percent)	6,880 (90percent)	9,338.4 (74percent)	1,985 (78percent)	7,293 (68percent)	18,813 (92percent)	4,261 (100percent)	1,741 (100percent)	0	0
Special Revenues as a percent of total funding	424 (11percent)	771.1 (10percent)	3,248.8 (26percent)	572.5 (22percent)						
Transfers from off-budget funds as a percent of total funding					3,454 (32percent)	981 (5percent)				
Sales of assets as percent of total funding						569 (3percent)				
TOTAL	100percent	100percent	100percent	100percent	100percent	100percent	100percent	100percent		
LEGAL BASIS										
Administered by legislation	X	X	X	X	X	X	X	X	X	X
Legislation specifies Board of management					X	X	X	X	X	X
FUNDING										
Assets property of the State –cannot be sold by agency	X	X	X	X						
Can own/sell assets	X	X	X	X	X	X	X	X	X	X
Funding provided almost exclusively by central budget		X				X	X	X		
Largely budget dependent-some revenue earning	X									
Significant revenue earning and retaining			X	X	X				X	X
FINANCIAL REPORTING TO WHOM										
Ministry of Finance	X	X	X	X	X	X	X	X		
Cabinet									X	X

(1) Core ministries : Finance, Development, Justice, Economy, foreign affairs, immigration, information, Labor, Trade, Local government; Sector ministries : health, education, culture, agriculture, environment, science, transport, urbanism, sport and youth; Other first line users : institutions with coding from 20001 to 38009 include judiciary institutions (courts, prisons), Statistics office, Academy of science etc. The second line users exist in five ministries only (education, labor, science, culture, sport and youth).

(2) The item main budget for all first line users covers wages, goods and services and capital investments (items 40, 42 and 46 respectively), current and capital transfers are excluded. For the off-budgetary funds main budget includes the revenues from earmarked contributions and transfers from the budget.

ANNEXES TO CHAPTER 3

ANNEX 3.1

THE FYR MACEDONIAN TREASURY SYSTEM

Responsibility of the Treasury Sector[23]

1. The first responsibility of the Ministry of Finance Treasury Sector is to implement the budget approved by Parliament. This involves both the recording and monitoring of expenditures to prevent over-expenditure and also the recording and monitoring of revenues to prevent an increase in the approved level of deficit. However, the responsibility for budget execution is broader than controlling actual expenditures and collections. It involves the coordination of cash and expenditures to assure smooth and uninterrupted execution of the budget.

2. The second and equally important responsibility of the Sector is to provide organized information to managers and to the budget planners so that subsequent planning can be improved.

The Treasury concept: Treasury Bank Account and Internal Treasury Ledger

3. The main tool used by the Government is to limit the number and the responsibility for government bank accounts. If government bank accounts are in the name of the Treasury or jointly held with the Treasury (as may be the case for foreign donation accounts), these can be monitored in accordance with consistent procedures that are transparent to all. When the treasury concept is new, the Treasury bank accounts may reflect the major budget divisions (and signature/management authority) such as the central Government budget, the budget of the health fund, the budget of the pension fund. With time, all budget divisions are included in the Treasury and the external bank accounts are decreased. After all, there is a significant decrease in bank commission charges when most of the financial transactions are within the Treasury system.

4. The Treasury then establishes an internal accounting system with accounts for each spending unit so that each expenditure and receipt can be monitored and compared to the budget approved by the Parliament. These internal treasury ledger accounts are established in an orderly scheme to separate the activities in the same manner as in the approved budget. The financial transactions (expenditures and receipts) are recorded using the budget classification system as in the approved budget. The daily net of inflows and outflows from this internal "ledger system" represents the turnover in the Treasury account in the bank. Unlike bank accounts that concentrate on the balance, these internal accounts mirror the approved budget providing information that is compatible with the budget. Internationally accepted accounting principles for budget institutions provide guidance for the accounting rules.

[23] This section draws heavily on observations of I. Castro and P.V. Desai (IMF)

5. These concepts are now being developed and implemented. The dismantlement of the Central Payment Bureau (ZPP) enacted in 2001 (ZPP Reconstruction Law) provides for the accounts of the budget users to be transferred to the Treasury from the ZPP. The Treasury is now in charge of recording revenues, processing payments, and accounting for all financial transactions. The Treasury has sufficient authority to consolidate Government funds in the NBM to a single account for Central budget. Some of the Funds, namely the Road, Health and Pension Funds, will continue to have their own "treasuries" and deal directly with the NBM or another bank (such as Stopanska Bank for the Pension Fund).

Treasury operations, 1995-2000

6. In order to measure progress in the development of the Treasury, it is important to understand that treasury development only began in 2000.

7. Recommendations for implementing a treasury system were made in May 1995 by an IMF mission.[24] After examining the accounts of the budget users in the ZPP and in the banks, the IMF mission could see a relatively quick way to implement a treasury system in FYR Macedonia. Its recommendations were that

- the shadow bank accounts of the budget users be closed,
- the balances be transferred to a single treasury account in the NBM, and
- the MOF make an agreement with the ZPP to use the giro accounts as internal accounts of the Treasury.

8. It was further recommended that, on a temporary basis and by agreement, ZPP continue payment processing operations for the budget users and also perform the additional tasks of coding revenues and expenditures in accordance with the classifications used in the budget, providing the MOF with appropriate reports of budget execution.

9. These recommendations were only partially implemented. Although budget users did close their accounts in the commercial banks, their balances were not transferred to a Treasury account in the NBM. Rather, budget users established an account in the NBM and transferred their balances to their own "single account." This account in the NBM was a deposit account and ZPP continued to perform transaction processing for the budget users as clients of the payment system.

10. With the exception that the ZPP coded revenues and expenditures for the central government general revenue accounts and had the capacity for providing this information, the treasury concept was not implemented. Moreover, since all MOF requirements were additional rather than changes to the ZPP normal payment system requirements, budget users paid little attention to any of the MOF requirements. Consequently, it is very typical now that spending ministry staff do not know their organizational codes or the economic classification – these were

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[24] IMF. Fiscal Affairs Department. "The Former Yugoslav Republic of Macedonia: Developing a Treasury System," Jack Diamond, P.V. Desai, and Feridoun Sarraf, May 1995.

just numbers they copied from the budget onto their payment orders. The only important thing was a correct giro account number.

11. Without the establishment of a treasury ledger system, budget users continued to own their accounts and operate as participants of the payment system under ZPP payment system law. Therefore, budget accounting methodology did not develop. In fact, each account was operated as a bank account. Budget users continued to receive funds from the budget account building up idle balances while the Government borrowed money to fund the budget.

12. There was also little change with respect to the Ministry of Finance staff. Without the implementation of the treasury within the Ministry of Finance, its staff did not keep pace with other transition countries in terms of developing knowledge and skill in financial management.

13. In 1997 another bank account was established, if requested, for spending units for "special" revenues which represented any revenues and expenditures that were not included in the budget plan. The *budget* was narrowly defined to include only those activities that could be supported from centrally collected general revenues. A legislation allowed to split general revenue, providing part of the collection to the "special" revenue account so it could be used without an approved budget. Over the four years, these "special" revenue accounts grew to be approximately 20 percent of the budget.

Establishment of the Treasury, 2000-2001

14. Therefore, until 2000 the Ministry of Finance had a limited view of financial management, restricting its work only to the distribution of the approved budget. It did not review and compare actual expenditures to released budget nor did it use actual expenditures as a source of planning the budget of the subsequent year. It also had no organized and regular cash management activities. Funds (and spending authority) were distributed to the NBM accounts of the budget users based on the amount of cash available. Fees to the ZPP were paid whenever cash moved into a budget user's account, from one budget user's account to another and from the budget user to the final recipient. As cash became more scarce, the control over the distribution of cash and spending authority was tightened and spending units had to specify what payments they wanted to make before the distribution would be made. This policy led to the creation of arrears but it did not reduce the idle balances budget users built up.

15. Issues of control, especially in the use of the special revenue accounts without parliamentary oversight for on-budget operations, and the lack of transparency in foreign assistance expenditures continued and, at the end of 1999, the Ministry of Finance requested assistance from the IMF for Treasury operations. The new Minister of Finance who took office in January 2000 supported this effort to improve financial management and the new effort to establish a Treasury at the Ministry of Finance began again.

16. During late spring a separate Treasury Sector headed by an Assistant to the Minister was established within the Ministry of Finance. This Sector is developing the management structure of the Treasury, giving direction to its operations and developing accounting procedures that provide the required transparency and ensure the ability to supervise budget execution.

Staffing of the Treasury Sector

17. Prior to 2000, there were no staff that could be identified as working on the Treasury within the MOF. In 2001, the 15 staff were joined by additional staff from the Central Payment Bureau (ZZP).

18. A main priority has been the training of these staff so that they could be distributed effectively among the necessary Treasury operating units to develop the necessary procedures and begin the required tasks. The new staff were primarily recent graduates of the Economic Faculty with no job experience. The training program consisted of the weekly in-house lectures, subsequent reading assignments, and one-on-one training for specific activities. Some care has been taken to cross-train staff and there is a great deal of teamwork so that information is shared freely.

Organization of the Treasury

19. The Treasury is organized to perform the normal treasury functions:

Budget Execution.

20. The budget execution unit is in charge of ensuring that expenditures do not deviate from the budget. It is organized such that staff are assigned responsibility for specific units and programs and most of its staff have experience at the Ministry. The unit the budget releases (monthly plans), approves the payment requests, and funds the payment orders. The ZPP only collects and inputs the payment requests and then clears the payments and performs the settlement operations. After completion of the ZPP restructuring (expected in 2002 or 2003), the function will be performed by the banking system. The procedures for budget execution for 2001 are described in the section *2001 Procedures.*

Cash Management.

21. The staff of the cash management unit are all young and recently recruited. One staff member of this unit participates with the NBRM in weekly meetings on liquidity. Several approaches are used to estimate revenues, including a monthly revenue-estimating model.

22. In late spring of 2000, software was installed to allow the Ministry of Finance access to the Treasury database at the ZPP. (This approach had been available earlier but was not used.) The Treasury defined the transaction reports it required so that it could begin to track expenditures and implement regular reports. The cash management unit has been responsible for the control of salary payments, obtaining their reports from the transaction data supplied by the ZPP. Reporting on arrears and other issues was likewise a task on this unit. The staff of the unit has some expertise in ACCESS and is able to format the transaction records released by the ZPP into useful reports. This unit works very closely with the budget execution unit.

23. This unit is also working on the foreign exchange accounts of the budget users. With the information now available new procedures were being developed in 2001. Meetings are in progress with the NBM to find the optimum procedures for managing donor and loan foreign currency accounts.

Debt Management

24. The Debt Management unit has implemented a register of guarantees and is working with the International Finance Sector in the MOF and the NBM to develop appropriate reports on foreign indebtedness. The MOF is currently pursuing funding for the necessary training, software and hardware to operate the DMFAS system used by the NBM. The work of the unit will improve with further training and acquaintance with debt management and its issues.

Accounting and Reports

25. Until 2001, accounting has been regulated by the ZPP through procedures published in its *Official Gazette of the ZPP*. These procedures are consistent with the management of a bank account but do not meet the needs of budget accounting. The 2001 procedures, although they will provide increased control and management, represent difficult compromises between the Treasury and the ZPP obtained subsequent to many documents and discussions. As mentioned above, each change of procedure requested by the Treasury must be, in effect, a decree of the Minister and, except for informal discussions, the Treasury may not directly request any service of the ZPP.

26. There may also be a limit to which a payment system can accommodate the Government's requirements for management and control. Chief among the constraints that cannot be surmounted are the construction of the account number to reflect some order, such as sources of funds. Another is the non-standard definition and use of accounts and sub-accounts. Accuracy of accounting records is also a problem because the payment system cannot accommodate the specific procedures for intra fund cash transfers and also expenditure and revenue refund recording. The Treasury views the compromise solutions currently in place as temporary.

27. The written accounting instructions are outdated. Therefore, the Treasury has completed a manual of Treasury accounting procedures that meet the appropriate international accounting standards for public sector accounting. The chapters of the manual address the following:

1. Chart of Accounts
   - structure of coding
   - usage
2. Budget Execution
   - procedures
   - reporting format and content
3. Annual Accounts
   - format
   - guidance on completion/consolidation
   - link to accounting standards
4. Record Keeping
   - principal financial records
   - guidance on use
5. Internal Controls
   - principles

- practical guidance
6. Glossary

Treasury Single Account

28. The law on ZPP reconstruction was adopted in February 2001. The law transferred all budget institution accounts and the responsibility for recording government revenues to the Treasury as of July 1, 2001 (although a transition period is allowed until December 31, 2001). It also transferred the collection of taxes to the Public Revenue Office. A new law on the Public Revenue Service has been passed that gives the appropriate authorizations. An amendment to the Law on Budgets provides the necessary authority to the Treasury to manage an internal Treasury Ledger System and to manage all government bank accounts.

29. The Treasury has been eliminating the idle balances from the budget user accounts. This approach frees the Treasury from engaging in individual account closures. In addition, in view of the difficulties encountered in changing the ZPP software for minor procedure changes for 2001, the Treasury does not want to add this additional work to ZPP. During 2001, the Treasury has reviewed all existing accounts and classified them to secure a smooth transition form ZPP.

Treasury Software

30. The MOF has duplicated most of the payment processing software that the ZPP has except that the ZPP programs are on an MCP platform using COBOL programming and indexed files while the MOF programs have been developed in a database environment making them more efficient to use and change. The MOF software is also used by several of the larger spending ministries, but their applications include an accounts payable module (this is the initial stage of capture of the expenditure transaction) and more expanded reporting capability. The intent is to operate in parallel and to phase out ZPP's involvement in the payment processing activity until an integrated software is developed. The MOF has developed revenue recording function.

31. The Government is working with donors to develop an integrated Treasury system. It is expected that the work would start in early 2002 with the development of Treasury functional specifications followed by the purchase and installation of the software.

Central Budget Format

32. The budget users were encouraged to submit the budget drafts to provide greater transparency regarding their activities. Therefore, many budget users identified the major activities they perform (called programs) and reflected planned expenditures (and revenues) by these programs.

33. Planned expenditures of the Central budget are shown by activity at the item level and consist of several columns: 1) the central budget containing the normal functions of executive, legislative and judicial organs funded by general revenues collected as a function of the power of government, 2) the central budget containing normal governmental functions but funded by agency collected general revenues, 3) the self-funded activities containing those supplemental

functions of government institutions that can be said to be business-type operations, 4) activities funded by foreign grants and donations, and 5) projects funded by credit programs (loans).

34. Planned revenues are also shown in 5 columns and include: 1) tax and non-tax revenues collected centrally as a function of the power of government, 2) fees and reimbursements for normal governmental services collected by the budget institution to offset the cost of providing these services, 3) proceeds from sales for products and services for business type activities, 4) grants and donations for specific and discretionary purposes given by private individuals and foreign donors, and 5) loan funds for reform and investment related activities.

Law on Budget Execution

35. The Law on Budget Execution provides flexibility for the Ministry of Finance to recognize additional workload in case of over-realization of revenues in columns 3-5. Should a grant be awarded or a new credit program concluded, the Ministry of Finance would be able to allow the associated expenditure increases. In addition, in this first year, there has been some under-reporting by the budget users, especially concerning their accounts in foreign currencies.

36. The Law on Budget Execution also provides flexibility between the programs as identified by the budget users. Again, since this is the first year of providing more detailed budgets, the budget user may not have had sufficient data to develop a very accurate plan.

New Accounts

37. With the execution of the 2001 budget, the Treasury has established new series of giro accounts to correspond to the new budget format. Account 630 records centrally collected general revenues, account 631 records agency collected general revenue and is shown for each spending institution making these type of collections, account 637 is the expenditure account for the general budget, account 787 receives the revenues and records expenditures for self-financed activities, account 788 is like the 787 account but for higher education, account 785 is used for grant receipts and expenditures, and account 786 for credit programs.

38. In addition, the organizational classification used to identify the budget accounts has been expanded by three digits to include major activity and subactivity code.

39. The Treasury has implemented communication rules that do not allow the transfer of budget funds to discretionary accounts.

Monthly Plan

40. Budget execution begins with a monthly plan that is submitted for each account. The plan of expenditures is in the same format as the budget – at the item level. This is submitted on diskette or in paper format. The Treasury approves the monthly plan, and records it in the MOF Treasury Financial Transaction System (uploads). In cases where the Ministry has second level budget users, only the program level monthly plan is approved by the MOF. Budget releases to second level users are at the discretion of the Ministry; however, these must be reported to the Treasury in the established monthly plan format. Monthly plans are also submitted for self-funded activities, grants, and credit programs.

Payment Requests

41. Payment requests are submitted by the spending unit and accepted by the Treasury. The Treasury compares the payment requests with the approved monthly plans and with the cash available. Budget execution staff identify the source of financing for each transaction and record the expenditure (in the case of the general budget, the expenditures are recorded under the appropriate expenditure account, such as 603, 637, and the funding is indicated, as from 630 and/or 631. The TFTS retains all expenditure transactions for reporting purposes. An additional procedure exists for emergency payments and involves the approval and submission of payment orders by the Treasury for processing during the same day.

Revenue Recording

42. At this time all revenue-recording operations are still performed in the ZPP and daily reports transmitted to the Treasury. These operations include:

- Collection of receipts for taxes, fees, penalties.
- Recording of receipts collected by the Post Office.
- Distributing funds to central government account, local government accounts, to accounts of Funds.
- Receipt transaction recording.
- Reporting receipts to appropriate agencies (including taxpayer information to PRO).

43. Collections can occur at any of the 10 branches, 16 sub-branches or 6 agencies. In addition the Post Office also takes in receipts from citizens for budget accounts and these are recorded by the ZPP. No changes were made to the above procedures for the start of 2001, except to add the requirement of recording revenue codes for all accounts now included in the 2001 budget.

Grants and Credits maintained in foreign currency at the NBM

44. During 2000 some grant and loan accounts awarded in foreign currency were kept in the NBM and transactions were processed from these accounts. Other grants and loans were merged with the budget or special revenue accounts and expenditures recorded there. In 2001 a separate account was created for each grant and credit program with sub-accounts when different sources of funds are used for a project funded in part-by a loan.

Summary

- The Treasury single account will be fully implemented once the accounts are transferred to the Treasury ledger (2002).
- Comprehensive coverage of all budget institution accounts.
- Integrity of revenues and expenditures (separation of budget activities, self-financing, grants, credit program).
- Control of budget execution.
- Approval of payments.
- Control of cash and elimination of idle cash balances.

- Cash management (revenue and expenditure forecasting).
- Initiation of the debt management function by implementation of a register of guarantees.
- Development of budget execution procedures, accounting methodology and general ledger.
- Management reports.

ANNEX 3.2

THE AUDIT FUNCTION

External Audit

1. **Legislation.** The State Audit Law came into force on the eighth day from its publication in the "Official Gazette of the Republic of Macedonia, No. 65/97", that is, on 22 December 1997. Certain provisions came into force 180 days from this date, for example Article 17 calling for auditing standards to be published in the Official Gazette.

2. The called-for auditing standards were published in the Official Gazette, No.56/98. The standards adopted are those of the International Organization of Supreme Audit Institutions (INTOSAI). In general, the State Audit Law is a well thought out and comprehensive law.[25] It provides for:

- audit of all public entities, including those at the local level of government;
- broad scope audits, including matters of economy, efficiency and effectiveness;
- free access to needed information;
- independence of the State Audit Office in planning, conducting and reporting audits;
- appointment and dismissal of the Chief State Auditor and Deputy is by Parliament;
- term of office is for ten years, thereby covering two government terms;
- requirement to follow auditing standards;
- penalties for entities and responsible persons who limit the audit in any way; and
- reporting to Parliament.

3. The Law does not require the inclusion of recommendations in audit reports (nor does it prevent their inclusion). The State Audit Law does not provide for "follow-up" of actions taken by audited entities to correct reported weaknesses. Also, it does not require the Bureau to adopt a "quality assurance" process to assure itself that audit standards and processes are followed in the conduct of its audits. These matters could be adopted as part of the policies of the Bureau.

Audit Operations

4. Having strong audit legislation and being able to implement it are two different issues. The new Chief State Auditor took office only on February 2000, after the earlier resignation of the first Chief State Auditor. Needless to say, the State Audit Office is just being established and organized. It is not yet fully set up to be able to fulfill its mandate. Initial steps have been taken to organize the Bureau and to better understand the "audit universe", that is, all of the entities that are subject to audit. For example, time has been devoted to developing such things as operational manuals and internal By Laws. The Chief State Auditor fully understands the broad audit mandate set out in the State Audit Law, and has developed a staffing plan that calls for

[25] Annex2 sets out a more detailed summary of key provisions of the State Audit Law.

increases in the total staff. Until recently staff level was 11, consisting of the Chief State Auditor and his Deputy, seven auditors and two administrative support staff. During late 2001, 10 new staff was recruited (seven auditors and three support staff). The SAO assesses that it needs seventy-four auditors to cover the entire spectrum and plans to increase the number of staff slowly over the next three years.

5. Since there is an overall cap on public service wages (not to exceed the wages for 1998), this constitutes a freeze on hiring in the public service. During 2001, filling needed staff positions was tried to be achieved through transfers of existing staff from other organizations, which proved to be a very difficult task Later government allowed the SAO to recruit a small number of staff from outside.

6. Limited funding was provided for in the Budget, but the State Audit Office is permitted to charge audit expenses to legal entities, public bodies and the national bank, Funds, and others for its services. For 2000, the Budget provided for 8.1 million denars (and 9.8 million of its own revenues) for a total of 17.9 denars.

7. To date, a total of 36 audits have been initiated and they are at varying stages of completion. One audit report, dated 4 November 1999 was obtained for review purposes. In terms of audit coverage, the 36 audits are estimated to represent about 5 percent of total coverage. By the end of 2002, the expectation is that the cumulative coverage will increase to 25 percent, and that by the end of 2003, the coverage will increase to 70 percent with the balance of 30 percent to be covered by the end of 2004, if preconditions are met (primarily staffing and funding).

8. The State Audit Bureau is really just starting to implement its mandate. Needs identified by the Chief State Auditor included:

- a need to increase awareness and support, particularly from entities
- subject to audit;
- a need for additional audit staff with a high level of experience and
- expertise;
- an ability to offer competitive wage levels to attract and retain qualified staff;
- a need to develop in-house audit training programs and to obtain assistance
- in offering the training programs;
- an ability to develop international linkages, including fellowships, seminars
- and workshops as a means of exchanging knowledge; and
- a need for specialized training in the field of "performance auditing: or
- "value for money auditing" and in the field of computer auditing.

9. In addition, the following were suggested as additional possible areas for technical assistance:

- the development of a "Booklet" on the role and responsibilities of the
- State Audit Bureau would be of assistance in increasing awareness;
- the introduction of a "quality assurance" process to improve the quality

- and consistency of audits;
- on the job training of auditors to help ensure they understand and follow
- audit standards and Bureau policies and practices;
- setting up of a Web Site for the State Audit Bureau; and the
- development of an Audit Manual and Code of conduct to increase
- professionalism.

10. Based on these needs of the SAO, a technical assistance program has been developed by World Bank and funded by Dutch government. The program will be implemented between 2002 and 2005.

Audit Reporting

11. Article 12 of the State Audit Law calls for submitting the annual audit report to Parliament. It is understood that the Parliamentary Committee, "Finances and Budget Committee" would be responsible for receiving and reviewing the annual audit report. The first such report was submitted to the Parliament in 1999. This annual report summarizes the audits conducted during the preceding year and also reports on the work of the State Audit Bureau.

12. In order to gain an impression of the type of audit conducted and whether or not audit reporting standards are being followed, one completed audit report was requested from the State Audit Bureau for review purposes. The phrase "audit report" is used here to refer to the entire report of the auditor, including findings, audit opinion, and recommendations, if any. An audit report was provided, addressed to the Minister of the Department of Education, and was the subject of review according to the framework set out in Figure 1. The framework developed by the audit advisor consists of three segments: (1) required reporting standards; (2) suggestions for formatting audit reports, and (3) considerations of the impact of audit reports. The assessment comments represent the views of the audit advisor.

13. It is clearly understood that a sample of one audit report is an insufficient basis upon which to draw general conclusions. Nevertheless it may be indicative of how other audit reports are being prepared. There was insufficient time on this mission to have more audit reports translated and reviewed or to be able to judge any changes that may be initiated by the newly appointed Chief State Auditor. Also, no review of supporting audit files and evidence was carried out. The audit was a financial audit, including an opinion on compliance.

14. The following summarizes the results of the review set out in Table 1:

- Generally, the audit report is clear and concise.
- There are some serious audit findings and they are reported objectively.
- It appears that audit standards are followed, although the level of assurance provided from the work carried out is unclear.
- Main audit procedures actually carried out could have been described rather than what audits entail in general.
- Perhaps some factual background information on the entity could have been provided to help readers understand the context of the audit, but this is not required for financial audits.

- The audit report could have had standard sub-headings to help readers (scope, objective, findings, opinion, etc.), but the report reviewed is relatively short and in point form.
- Given the nature of the findings, it may have been helpful to include recommendations on what should be done to prevent repetition of weaknesses.
- Given the nature of the findings, it would have been preferable to have the audit report issued on a more timely basis but, then, the State Audit Bureau is just starting its operations.
- To assist readers of the report, management's explanations and reaction to the
- audit report might have been included in summary fashion.

15. In summary, the audit report represents a combined financial and compliance audit report. Formatting might be improved a little and recommendations could be included (either in the body of the report or as an appendix) as well as including management's comments to present a more complete picture.

Technical Assistance Recommendations on External Audit

16. The following recommendations are fully reflected to the technical assistance program of SAO. The proposed support is divided into three phases, including general estimates of the time needed to carry out tasks:

(a) a. Awareness (two months)

(b) b. Developing professionalism (six months) and

(c) c. Strengthening professional and administrative skills (twelve months).

Table 1: Criteria for Reviewing Audit Reports

Criteria	**Comment**
A. Standards	
Audit reports should state **that the audit was conducted in accordance with generally accepted auditing standards.**	Yes (INTOSAI)
Reports should state the: • Title • Recipient • Audit purpose • Scope of audit work, including o What was audited o Procedures followed o Time frame covered o Duration of the audit o Clarifications of qualifications, if any, prior to audit opinion/conclusion o Limitations in audit scope, stating procedures and tests that could not be carried out o Compliance with applicable legislation	 • No • Yes • Yes o Yes o Yes, in general o Yes, annual financials o No o Yes o Yes – F/S not accurate o Not in

Criteria	Comment
- Compliance audit opinion/conclusion - Date on which field work was completed - Place and date and signature - Comparisons with previous years/reports	- Yes - Yes -- 4 November 1999 - Yes (Skopje) - Yes, no previous audit
The audit report should: • Indicate significant weaknesses in internal control and appropriate recommendations • Contain appropriate recommendations where the audit identifies key opportunities for improvement in the entity being audited • Identify issues warranting further investigation or study • Contain in appendices other supplementary information of interest	• Yes • No recommendations • None mentioned • No
B. Format	
It would be helpful if audit reports, particularly Value for Money audit reports, would include: • An executive summary • A table of contents • Use of standard headings throughout the report • A background section to help set the context of the audit and pertinent information about the entity • Audit criteria • The use of charts, graphs, figures to improve user understandability and readability	• No • No • No • No • Yes • No
C. Substance	
• here should be some sense of audit importance regarding the findings (e.g., items should be prioritized). • Were auditing standards followed? • There should be a logical consistency through the report (from purpose, objectives through scope and criteria through findings and conclusions and financial audit recommendations). • Is the subject matter of the audit report of significance? • Is it written in a clear, understandable and unambiguous manner? • Did the audit report, or is it likely to, have a positive impact? • Was the audit worthwhile? Why? Why not? • Is the reporting approach "punitive" or "remedial"? • Is the reporting timely? • Are "management letters" issued setting out detailed findings?	• Yes • Appears so • Varies • Yes • Yes • Unclear, but may because of qualification • Yes • Financial audit – without recommendations • Should be earlier • Yes (but not reviewed)

17. It should be understood that many of the items identified are continuing processes and that the nature of the assistance is to help the State Audit Bureau initiate such actions and to allow it to become more self-sufficient over time.

18. **Awareness**. It is essential that the role and responsibilities of the State Audit Bureau be well understood and supported by Government including those subject to audit, by Parliament and by the general public. The State Audit Bureau, although created in late 1997, has issued annual reports to Parliament in 1999 and 2000. This is an ideal occasion to increase general awareness of its role, responsibilities and activities in strengthening accountability and building greater transparency within the public sector. Some activities to increase awareness would include the following.

(a) Develop a brochure/booklet setting out what the State Audit bureau is, what it does, how it carries out audits, and who it serves. The booklet would be in very simple and clear language and would be no longer than about 20 pages.

(b) Design a national/international seminar to present the State Audit Law, the annual audit report and the above Booklet. Representatives from INTOSAI, the World Bank and other international bodies would be represented, as would members of the Parliamentary, "Finances and Budget Committee". Subsequently, a suitable "Proceedings" would be prepared and widely distributed to members of Parliament, senior officials of Government, and so on.

(c) Prepare an <u>outline</u> for an "Audit Manual" and agree it with the State Audit Bureau.

(d) Prepare a Code of Professional Conduct, or adopt the Code suggested by INTOSAI, for use by the State Audit Bureau. The Code would be put into practice by designing a form to be signed annually by every State Audit Bureau staff member.

(e) Carry out a "training needs analysis" to identify an overall training program, identifying priorities and timing.

(f) Carry out a "needs analysis" regarding the computerization of the State Audit Bureau, identifying priorities and timing. Implementation of the computerization plan would most likely take place at a later stage.

(g) Develop a Web page for the State Audit Bureau based on the contents of the Booklet, mentioned in Item (a) above.

19. **Developing professionalism (six months).** It should be noted that increasing audit staff to a reasonable number should take place before implementing phases two and three.

(a) As more staff are hired and as more audits are carried out, it becomes increasingly important to establish a "quality assurance" process to help ensure that audits are carried out consistently and in accordance with accepted (INTOSAI) audit standards. First, the written procedures would be developed. Then, "quality assurance" reviews would actually be carried out on selected completed audits. Individual brief reports on the audit reviewed would be prepared and an overall summary report prepared, including recommendations for improvements where appropriate.

(b) An introductory training program, based on the "training needs analysis" would be designed and offered to all State Audit Bureau staff. The training program would include some sessions on financial accounting, managerial accounting, compliance audits, financial audits, and elements of performance auditing (or, value for money auditing). To the extent that the Government may be requiring the reporting of performance information by line ministries, the State Audit Bureau should be prepared and able to audit such information. Computer audit techniques would also be introduced both for using the computer to audit as well as auditing computer installations.

(c) An "Audit Manual" would be prepared in accordance with the agreed-upon outline mentioned in Item a (iv) above.

(d) An outline for a series of courses designed to build professional and administrative skills would be developed and agreed with by the State Audit Bureau. At the junior level, technical skills would be emphasized; at the managerial level, interpersonal and managerial skills would be emphasized; at the senior level, conceptual and strategic skills would be emphasized.

(e) An outline of an "on-the-job" training program would be developed and agreed with by the State Audit Bureau to help ensure that audits are carried out as set out in the Audit Manual under Item b (iii) above.

(f) A "Fellowship Program" would be designed whereby selected candidates from the State Audit Bureau would be sent on an exchange with another Supreme Audit Institution for several months. Likewise, a senior member from another Supreme Audit Institution could be invited to join the State Audit Bureau for an equivalent period of several months. A Fellowship Program tends to be costly in terms of both financial needs as well as the cost of the absence of staff and/or the hosting of others. Therefore, this action should be considered only when the State Audit Bureau is more established and stable. In the short term, attendance at shorter audit seminars sponsored by INTOSAI would be beneficial.

20. **Strengthening Professional and Administrative Skills** (12 months).

(a) A central audit planning "model" would be developed, taking into consideration the "audit universe" and available and planned resources, risk analysis, etc.

(b) A "time reporting" system would be designed and implemented to improve audit planning and efficiency. As well, an "audit filing" system would be designed and implemented to protect and properly store audit files and evidence.

(c) The "on-the-job" training program set out in Item b (v) would be carried out.

(d) "Performance audit" training would be carried out, including topics such as development of criteria, cause and effect analysis, development of recommendations, etc. Other courses included in the outline developed under Item b (iv) would be offered. The actual conduct of performance audits might only take place when laws are being complied with and when sound financial systems are in place and producing timely and reliable financial reports.

(e) The identification of a listing of appropriate "government-wide" audit issues as well as the design of an audit approach to carry out such audits. Such issues may include: an evaluation of internal audit; procurement; human resource management within the public service, government research; the four funds audited concurrently; environmental protection, etc. Several government wide issues (Tier 1) would be identified for audit each year along with audit of selected line ministries and other entities (Tier 2). Staff levels would have to be sufficiently high to be able to carry out mandatory audits first and still have sufficient resources available for "government wide" audits.

(f) Perhaps, by this time, the State Audit Bureau would be in a position to design and offer an interregional workshop for external auditors of neighboring countries. In this way, the best practices of Supreme Audit Institutions in neighboring countries could be discussed and knowledge exchanges.

ANNEXES TO CHAPTER 4

ANNEX 4.1

INSTITUTIONAL FRAMEWORK FOR HUMAN RESOURCE MANAGEMENT

1. Not surprisingly, given the recent enactment of basic legislation, the institutional framework that sets the "rules of the game" is still in the early stages of transformation. Ultimately this framework should function in a manner that (1) provides incentives and pressure for professional, politically-neutral management of human resources and (2) includes effective enforcement and oversight mechanisms that temper autonomy with accountability. The recently enacted Law on Civil Servants and the subsidiary legislation that has been put in place since its passage represent important steps toward establishing such an institutional framework. They will, of course, need to be effectively implemented if they are to yield their desired impacts.

2. There is no single best blueprint for institutional structure and assignment of responsibilities among organizations, since these should to be tailored to the specific conditions in each country. In principle, however, such a framework should address the following broad dimensions:

- setting policies and parameters for fundamental practices, including recruitment and promotion;
- building capacity throughout the administration to implement these practices;
- explicit civil service management responsibilities;
- oversight.

3. One of the challenges for FYR Macedonia's public administration reform effort is to strengthen the constellation of bodies responsible for fulfilling these functions.

4. Prior to the passage of the Law on Civil Servants, no organizational body had explicit responsibility for the development and implementation of human resources policies. The policy framework, such as it was, was shaped by several administration-wide regulations for human resource management, largely contained in the Law on Administrative Bodies and the Labor Code. (These included, for example, a requirement that external recruitments be advertised and conducted by a commission, certain fundamental principles for discipline, appeals and promotions proceedings.) Further development of these areas was left to ministry-level regulations[26], which must be reviewed by the Commission on Personnel Issues and the Government to ensure compliance with the aforementioned legislation. The recent Law on Civil Servants consolidates authority over policies and oversight of management of the civil service

[26] These include an Act on Organization and Systematization of Tasks and Activities, as well as internal Rulebook, for example covering wages or discipline.

(roughly one-third of public employment) in the hands of the Agency for Civil Servants (the "Agency"). The Agency, for instance, now must review all ministry-level regulations ("Books of Rules" and "Acts of Systematization") governing organizational structure and personnel management. It also gives the Agency an important role in key personnel management decisions, such as recruitment and selection as well as confirmation, while still leaving substantial management authority with the individual state bodies. The Agency, for instance, administers the tests for short-listing candidates for civil service positions, and has representatives sitting on final selection committees; while the majority of members of those final selection committees are appointed by the individual state bodies. In short, the new Law on Civil Servants creates an opportunity for establishing a more consistent institutions for the management of civil servants. Whether this transpires in practice, and whether those institutions effectively focus civil servants on performance will depend decisively on precisely how the Law on Civil Servants and its companion legislation is actually implemented.[27]

5. Thus despite the absence until very recently of a body (or bodies) with explicit policy responsibility, there is a fair degree of consistency in major regulations throughout the administration. However, these regulations are largely piecemeal (rather than part of an integrated system of incentives and checks) or incomplete. As a result, similarly to policy-making at the central or sectoral level, the development of human resources policy is weak in strategic focus as well as comprehensiveness.

6. Nor is there effective organizational capacity to transfer policy into day to day practices. While basic regulations may be similar across ministries, only the Cabinet Office and four ministries (Interior, Defense, Foreign Affairs, and Finance) have their own human resources department[28]. These ministries are generally those that face special needs arising from the functions and composition of their workforces.

7. Until the creation of the Agency for Civil Servants, FYR Macedonia also lacked an independent body with a clear mandate and authority to oversee fairness of human resource policies and management. The Commission on Personnel Issues (and its Secretariat, in the Cabinet office) provides some limited oversight through its role in approving ministry-level rulebooks and systematization acts, and serving as an appeal body of second instance for general staff (the first instance appeal being the relevant minister), and of first instance for the higher officials who are appointed by Government at the Commission's recommendation.[29] However, the functions and features of this body fall short of those that ultimately should be assigned to a full-fledged oversight institution. The Commission, composed of ministers, is not politically

[27] The companion legislation would include both the subsidiary legislation for the Law on Civil Servants, as well as related legislation, such as the Law on Government, the Law on the Organization and Work of the Administrative Bodies and the Law on General Administrative Procedures.

[28] The personnel files of remaining central ministry staff are held in the Cabinet office, while those of ministry staff in regional offices are held by the relevant deconcentrated office of the Ministry of Justice.

[29] The Secretariat to the Commission reports receiving approximately 100 appeals in the past year. Of these, the largest number were from unsuccessful job applicants; very few related to firings or other issues. In addition to limited oversight and appeals functions, the secretariat serves as the personnel department for the Cabinet Office and is also the repository for personnel records of higher officials and regular staff in central offices of most ministries (personnel departments in the ministries of Interior, Defense, Finance and Foreign Affairs maintain records of their own staff).

independent; reflecting the generalized lack of a performance-orientation, its Secretariat lacks the capacity to monitor and evaluate civil service management and performance, and regular reports of activities and their outcomes (for example, the number and results of appeals) are not available. The Agency is intended to partially address this need. It is independent, its head being appointed by Parliament. But whether the agency actually succeeds in meeting this institutional need for effective oversight of personnel management to ensure fairness, and merit- and performance-orientation remains to be tested.

ANNEX 4.2

MANAGEMENT POLICIES AND PRACTICES

General Management Culture

1. As has been emphasized throughout this chapter, FYR Macedonia's administration focuses on inputs and compliance with formal regulations rather than on outputs or outcomes and the performance necessary to achieve them[30]. Decision-making power tends to be concentrated at the top of the hierarchy within any given state body, with many decisions that might under more devolved systems be made by middle or senior managers being channeled up to ministers or the Cabinet. While formal emphasis is on compliance with rules (as enforced by the various inspectorates), reports on actual practices are mixed. While on one hand several officials noted that staff are careful to obey rules in order to safeguard their jobs, other reports document how politicization undermines discipline and authority.

2. Such politicization can be expected to have a detrimental effect on employee behavior in any country, but particularly in one like FYR Macedonia, with a high unemployment rate and uncertain private sector prospects. On the one hand, employees without political connections may divert significant attention away from substantive activities toward safeguarding their posts. This may mean focusing narrowly on compliance with written regulations over achievement of organizational objectives, avoiding decisions that may disturb vested interests of the politically powerful, or indeed steering clear of any initiatives that depart from the status quo. Those employees who do enjoy political protection may also have weak incentives to focus on strategic objectives (or indeed, on job performance), since their primary loyalty will be to politically influential individuals, rather than to a legitimate organizational mission. In either case, this dynamic disrupts any legitimate organizational hierarchy, with some individuals (including managers) reluctant to fulfill their legitimate mandate, and others all too willing to flout such mandates. The newly created Agency for Civil Servants enjoys a legal framework that could permit it to address many of these management culture problems. Whether it achieves this depends on how it implements the provisions of that Law and its subsidiary legislation.

3. Budget decisions, like others, are centralized in the top levels of the hierarchy. Budgetary resources are allocated by line items, rather than for specific programs. The dominant expenditure item by far is personnel costs which account for 24.1 percent of total expenditures by general government. A prohibition on transfers between personnel costs and other categories effectively reduces the potential for managers to exercise any significant degree of discretion over spending. Consistent with the absence of a program orientation (with focus on outputs and outcomes rather than inputs) in the budget, the concept of accountability for performance is largely unknown and unsupported by formal processes.

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[30] For example, Ministry of Justice's Administrative Inspectors monitor implementation of the Law on General Administrative Procedures and related sector-specific regulations (particularly in urban planning and construction). However, the focus is on narrow compliance with procedures and educational requirements for staff, and does not in any way address productivity or similar issues.

4. As might be expected under such a system, not only is accountability for meeting strategic policy priorities weak, but so also is the orientation toward serving citizens. Some service standards (such as issuance of passports, drivers licenses, construction licenses) are regulated by relevant bodies and widely known. Under the Law on General Administrative Procedures, written inquiries must be answered within fifteen days. Provisions are also made for citizens to register complaints at the point of service delivery, though no formal user surveys or feedback mechanisms are in place. The ombudsman's office also receives citizen complaints, as do various inspectorates.

Human Resource Management Policies and Practices

5. FYR Macedonia's human resource policies and practices require significant reforms in order to systematically focus staff on the pursuit of strategic objectives. These reforms should include introduction of robust systems for competitive recruitment and promotion, performance appraisal and discipline. At present, some of these processes (notably performance appraisal) are essentially non-existent, although the Agency for Civil Servants is now starting to introduce consistent performance appraisal policies and procedures for civil servants throughout the public administration. Others are nominally in place, but neither comprehensively structured nor subject to adequate oversight (whether in the form of explicit monitoring and review, or structural and informal incentives that curb abuses). This is particularly significant given that formal decision-making authority in FYR Macedonia tends to be concentrated at the top of each organization, in the hands of politically-appointed ministers and agency heads. The autonomy enjoyed by these individuals can conceivably produce positive results, when their personal objectives coincide with government's strategic aims. However, without accountability mechanisms to enforce a focus on such legitimate objectives rather than private ones, the risk of a negative outcome is high. And, in all cases, the inevitable political turnover --whether a change in government, shift in the balance of power within the executive, or the departure of a particular minister or manager -- means a fundamental instability in the objectives driving organizational and staff behavior.

6. In practice, human resource management is largely discretionary. Certain standards are prescribed centrally, in the Law on Administrative Bodies, the Labor Code and the Law on Civil Servants, and the Cabinet as well as Commission on Personnel Issues exercise a limited extent of oversight on certain appointments (higher officials) and practices (by hearing appeals). Compliance with these centrally-mandated procedures and standards appears to be good, at least in the case of recruitment procedures. With the passage of the Law on Civil Servants, FYR Macedonia now has a legal framework that both reigns in such discretion to a limited extent within the civil service, and provides for more systematic oversight of its exercise. As noted numerous times above, the challenge now faced is to effectively implement that Law and its subsidiary legislation.

7. Until the Law on Civil Servants was enacted, staff planning, on the other hand, was not a centrally-exercised function and appears not to have been practiced by ministries or other agencies. Outside the civil service, each body makes its own hiring decisions, in compliance with the procedural regulations and formally within the bounds of the enumeration of authorized posts in its Act on Systematization of Tasks and Activities, but such actions have not typically been consistently linked to any forward looking staffing strategy. Some of the underlying reasons for

this state of affairs are readily evident; budget constraints and formal restrictions on hiring have been so strict as to make the development of any forward-looking strategies both of limited utility, as well as a drain on scarce professional resources, where these have been in place. It should also be noted, however, that the very capacity to engage in this sort of management exercise appears to be sorely lacking in the administration, not having existed under socialist rule or been fostered by prevailing incentives since then. Again, this situation may change within the civil service, if the Agency for Civil Service manages to ensure that Law is implemented as intended.

8. Indeed, the degree to which human resource management has been neglected is evidenced by the fact that only four ministries (Interior, Defense, Finance and Foreign Affairs) have their own personnel departments. Even without a formal personnel department, some basic functions are secured in other bodies, either by the Ministry of Justice or Cabinet office's personnel department in the case of personnel records[31], or via other channels as, for example, with recruitment commissions. The Agency for civil Servants is slated to absorb this function for the civil service. However, the fact remains that dedicated capacities and specialized skills for human resource management have not, until now, been provided for. Not surprisingly, given this situation, information on the workforce profile is not held in a form that would be readily-usable for planning purposes, although at least one of the ministries (Ministry of Interior) with a dedicated personnel department does have a computerized personnel information system that could be used, for example, to analyze turnover. The decision to establish a central personnel register, as mandated by the Law on Civil Servants, represents a first step toward alleviating this system-wide information deficiency.

9. Similarly to several other post-socialist countries, FYR Macedonia has not had any formal performance appraisals, although enactment of such a system for civil servants is now required by the new Law on Civil Servants. Introduction of formal appraisals will be an important step toward introducing explicit accountability, both of staff for performance of their duties as well as of managers for performance of their units or organizations. Additionally, such a system could be made more robust as well as more useful by linking it to other components of administrative reform process. Two potential uses come to mind. First, FYR Macedonia faces questions regarding how to confirm individuals into the civil service; one method might be to link this process to satisfactory performance evaluations, thereby ensuring that the evaluation process is actually implemented and also understood to be more than a pro forma exercise. Second, performance appraisals could serve as one component of a medium-term strategy to build an administration equipped with appropriate skills and staff numbers. Discussions with senior officials indicate that, while they recognize that some staffing cuts as well as redistribution of staff may be necessary, the basis on which such unpopular decisions might be taken is far from clear. This innately difficult process is further complicated by the political vulnerability of senior posts in the administration, whether at the level of higher officials or supposedly permanent staff, as well as by the weak mandates and related tendency to funnel decisions to the highest level. The performance appraisal system could provide a relatively more objective basis for retrenchment, thereby enhancing the likelihood that such measures will actually be implemented.

[31] MOJ deconcentrated offices keep records of deconcentrated ministry staff, while Cabinet office keeps records of centrally-located ministry staff from ministries without personnel offices.

10. The current recruitment system exhibits some promising features such as mandatory advertising whenever external hiring takes place.[32] However, this requirement does not extend to promotions into the ranks of higher officials, nor for vacancies that are filled with candidates from within the administration. The latter case, which is said to be relatively rare, is generally conducted informally and settled by agreement of the respective ministers to transfer staff[33]. When competitive external recruitment does take place, Article 184 of the Law on Administrative Bodies requires that a recruitment commission be assembled; compliance with this measure is reported to be high. The Law does, however, leave significant discretion to agencies, for example in the composition of the recruitment commission. Specifically, third party oversight is not required, although some bodies such as the Agency for Common Services regularly include external specialists in their commissions. With the passage of the Law on Civil Servants, competitive recruitment of civil servants appears more promising. The Law and its subsidiary legislation provides a solid legal framework on this dimension. Implementation is, again, the challenge.

11. Promotions outside the civil service are regulated to a lesser degree that falls short of fundamental standards of openness and transparency. Again, in light of the current budgetary and hiring constraints, promotions are said to be quite rare, occurring only when a corresponding vacancy occurs. Formally, promotions outside the civil service are decided by the Minister, based upon his/her estimation of the staff member as well as that of the individual's manager. Neither third party oversight, nor formal publication of promotions results (except that of higher officials, which must be published in the official gazette) are required, shortcomings that are particularly unfortunate given the importance of political appointees (the minister) in the decision-making process. Appeals, if any, are handled by the usual commission of second instance or, subsequently, by the courts. Within the civil service, it remains to be seen how promotions will be handled. But the Law does give the Agency an important role in overseeing promotion practices. In short, the opportunity exists to improve this dimension of personnel management within the civil service. Whether that opportunity is seized will be a test of how effectively the Law on Civil Servants is implemented.

12. Job descriptions are included in each organization's systematization act, and vary from brief entries to detailed listings of duties, as for example at the Cabinet Office and Ministry of Finance. The extent to which such job descriptions are actually used, for example in the hiring process, is unclear. In practice, there are indications that the delineation of any given job may be weak, constituting too diverse a grouping of responsibilities or cutting across working units[34]. This may be particularly in evidence in certain ministries that experience an acute shortage of professional staff and as a result have small units with too few staff to carry out the work..

13. As is the case for recruitment, basic regulations for disciplinary measures are contained in the Law on Administrative Bodies, and may in future be further specified in agency-level collective bargaining agreements, such as that under preparation by the Agency for Common Services. Not surprisingly, the collective agreement of the Ministry of Interior (which is responsible for police services) also contains well-elaborated regulations regarding discipline.

[32] The decision to undertake an external recruitment process is made by the respective Minister.

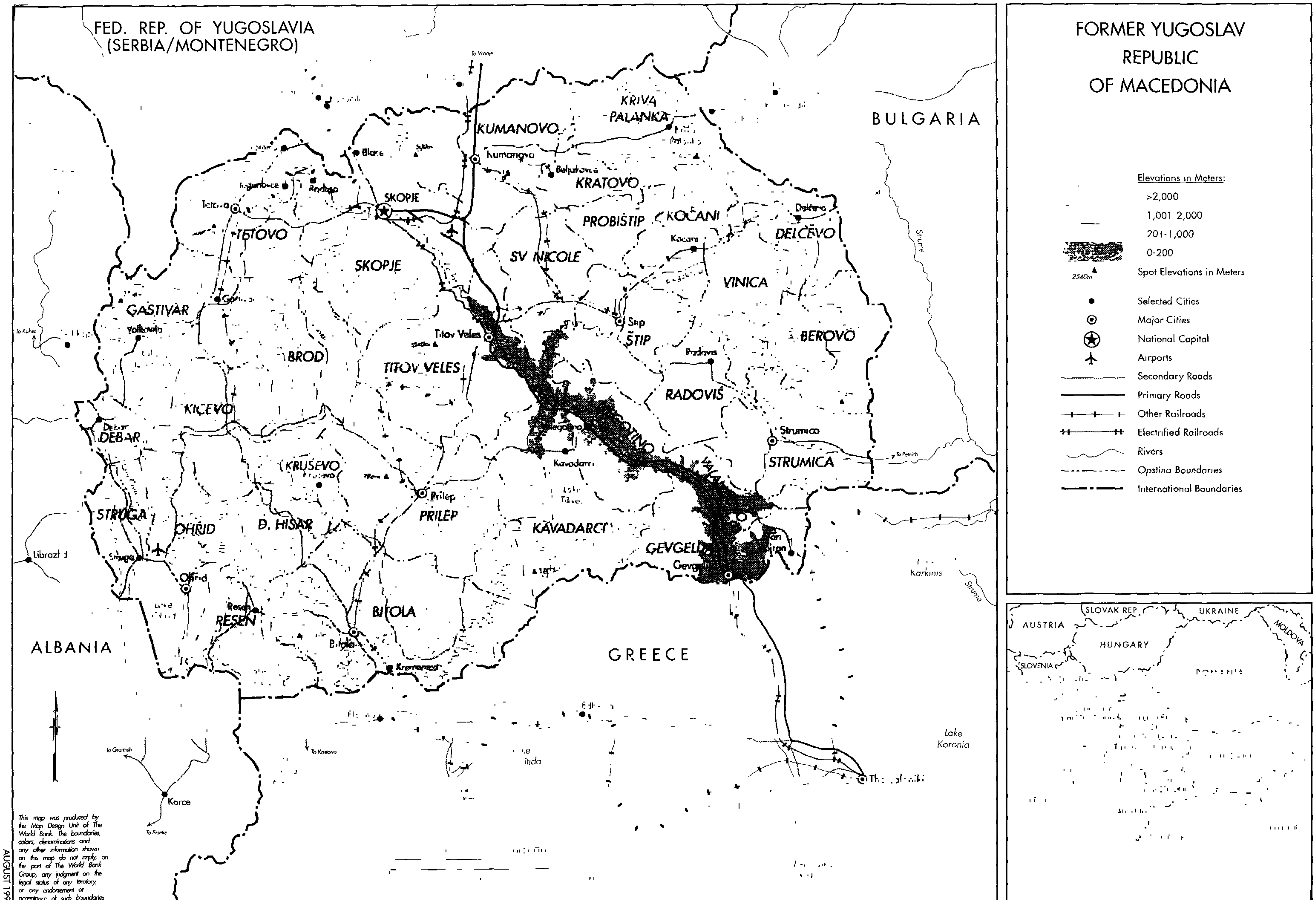
[33] If a larger number of vacancies is to be filled internally, the organization may request Government and other ministries to suggest candidates, as was done by the Ministry of Justice in one instance.

[34] Brian Finn, Phare analysis of MOF

Until its amendment in 1998, the Labor Code also contained some provisions regarding discipline. Since these were commonly referenced by agency-level systematization acts, the amendment has resulted in some confusion regarding the nature of regulations that are in effect. Within the civil service, the Law on Civil Servants and its subsidiary legislation lay down basic principles governing disciplinary actions.

14. Statistics on disciplinary actions are not kept, but formal hearings are reported to be rare[35]. Indeed, managers interviewed expressed a preference for resolving disciplinary issues via informal dialogue, rather than formal hearings. This attitude, in evidence elsewhere in the region, is to a significant extent a reaction against the excessive discipline practiced under the socialist regime. During that time, special rulebooks on discipline were the norm. Some organizations in the administration have retained this practice, while others rely solely on the provisions in the Law on Administrative Bodies. It may also indicate a reluctance to undertake actions that may result in drawn-out and costly appeals. For example, one ministry cited the cautionary example of a dismissal that was overturned several years later on appeal, with the ministry obliged to reinstate the employee as well as pay compensation.

[35] Several senior managers interviewed could not recall any disciplinary hearings having been conducted in their ministries, while one individual noted only two cases of disciplinary hearings and dismissal in the last seven years, one of which was overturned on appeal.



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