

# STRATEGY OF PUBLIC FINANCE MANAGEMENT REFORM

## 1. Introduction

The government committed in its Program declaration to decrease the general budget deficit of public finances to 3 % of GDP by the end of this electoral period. This commitment means not only the formal fulfilment of one criterion conditioning the membership in the European Monetary Union but at the same time implementation of such reform of public finances which will ensure that the public finance domain will:

- from a macro point of view become a factor supporting macroeconomic stability and overall stability of the economic environment
- from a micro point of view ensure smooth and trouble free financing of state functions as achieved by political consensus.

Public finance reform leading to consolidation is necessary for fulfilment of our obligations arising from European Union membership and also for speeding up nominal as well as real convergence which is an important pre-condition for Slovakia's entry into the European Monetary Union.

Complex public finance reform includes reforms in the areas of public expenditures (healthcare, pension system reform), revenues (tax reform) and public finance management, with the consequent creation of room for decreasing taxes and fund contributions. This document formulates the strategy in the area of public finance management reform.

Since 2000 Slovakia has made significant progress in improving the management of public finances. This is confirmed in a document called „Report on fulfilment of standards and rules –fiscal transparency module“, published by the International Monetary Fund in July 2002. This has also been confirmed by the conclusion of negotiations with the European Union in chapters dealing with public finances and by the acceptance of fiscal notifications and the Pre-accession economic program by the European Commission. Changes were focused mainly on the following areas:

- cancellation of nine state funds and their incorporation into budget chapters
- improvement of financial audit by adopting the Law on financial and internal audit
- creation of methodology for preparation of the medium term fiscal outlook and the Pre-accession economic program based on EU requirements

- elaboration and implementation of methodology for transformation of reports developed on cash base to the ESA 95 (EU) and GFSM2001 (IMF) methodology (accrual principal)
- limitation of the possibility for the creation of uncontrolled deficits by local administration and social insurance funds
- conceptual improvements in budget preparation by strengthening the importance of the budget envelope
- improvements in linking budgetary units during budget preparation
- implementation of the pilot project of program budgeting (result oriented budgeting)

#### **Commitments arising from Slovakia's membership of the European Union.**

During the pre-accession phase, accession countries introduce reforms and policies necessary for meeting the Copenhagen criteria – creation of a market economy and ability to cope with competitive pressure and market forces within the EU. At the same time the part of legislation connected with EMU membership, which introduces the first building block of the macroeconomic framework, must be accepted and implemented before accession.

Immediately after accession the new member countries will have to show conformity with particular articles of Chapter 7 of the European Communities Agreement and with other *acquis* connected with the EMU. These include:

- implementation of economic policy as a matter of common interest and coordination of economic policy between member countries through participation in community procedures (article 98 and 99)
- avoiding an excessive public finance deficit and conformity with particular determinations of the Stability and Growth Pact (article 104)
- progress towards achieving a high level of long-term sustainable convergence (article 124)

After accession the common macroeconomic framework becomes more obligatory, with a strong request for fiscal discipline and integration of other economic policies. The exchange rate policy becomes a matter of common interest, which means that member countries should avoid policies leading to excessive fluctuation of the exchange rate or its separation from economic performance parameters. Economic policy becomes a matter of common importance and a matter of coordination and multilateral procedures supervision. Convergence programs, general economic policy rules and a growing number of tools that deal with structural policies will become main coordination tools.

Budgetary policy and its results will be restricted by the excessive deficit procedure and to those parts of the Stability and Growth Pact, which are not tied with sanction recourse. The Stability and Growth Pact is a base of the EU framework for multilateral budget supervision.

The main commitment coming out of the Pact is the goal to reach a budget position close to balance or surplus. Stable and sustainable public finance development is considered a precondition for reaching a high level of long-term sustainable convergence. The Pact stresses the provisions of the European Communities Agreement dealing with fiscal discipline in the EMU also for EU member states with derogation. The Pact presumes annual elaboration and evaluation of medium term macroeconomic programs and their updating. New member states will therefore need to prepare Convergence Programs. Convergence Programs should provide a real base for price stability and sustainable growth leading to creation of new jobs. In the framework of Convergence Programs countries will have to formulate a medium term fiscal position goal of close to balance or surplus of public finances including the tools for reaching this goal, expected development of the general government debt and medium term currency policy goals in relation to price and exchange rate stability.

In spite of positive evaluations, the changes introduced to date have been rather a consequence of external pressures related to the pre-accession process, than the expression of the own, internal need to improve public finance management. The changes were isolated, without common links and were more of a technical and methodological character, without creating the necessary institutional framework – personal, organisational and information capacities were based on the enthusiasm of individuals, rather than the creation of a system.

Without sustainable changes in public finance management and ensuring consistence of the reforms by setting priorities and a timeframe, there is a risk that the Government and the Parliament will face permanent fiscal stress, and will continue to face the possibility of unexpected surprises, which need to be resolved immediately. Furthermore, these decisions will be made with the knowledge of short-term impact and risk (annual) only, i. e. without the knowledge of medium and long-term risks and impact.

Public finance management reform is necessary in all developed countries (from this point of view it is not a typical „transition“ agenda) and the majority of them are in some stage of implementing change. There is no uniform guideline regarding the extent of the changes, but there is ”best practice” from the countries, which first started to reform the public finance management system and have a long experience in this area. There are also some general principles, which arise from integration and globalization tendencies. These best practice and principles have been formulated by the OECD, and IMF.

#### **Institutional changes in budgeting (OECD)**

The OECD identified seven key institutional elements, which are necessary for effective public finance control. These are:

- medium term fiscal framework,
- conservative predictions,
- budgeting from „top-to-bottom“, based on priorities,
- transparency,
- liberalization of central control of inputs,
- results orientation,
- modern financial management procedures.

Even though the above are mentioned as seven independent elements, in reality they are mutually related and they must be understood as a package.

Source: Budget Reform in OECD Member Countries: Common Trends. Meeting of Budget Directors from the G-7 Countries. Berlin, Germany, 5-6 September 2002.

Public finance management reform is a long-term process. The goal of this Strategy is to identify particular reform components, their mutual relations, time and content restrictions

and to suggest priorities and the time frame for implementation of reform steps, including identification of areas with the highest need for institutional framework strengthening.

## **1. General direction of the reforms**

Successful support of macroeconomic stability assumes that public finance development will be predictable and macro economically sustainable. Reaching this stage presupposes the existence of a medium term fiscal framework, which is based on credible assumptions and contains an analysis of potential fiscal risks.

For the creation of a medium term fiscal framework based on credible arguments it is necessary to know the initial status of public finances, including the extent of liabilities and claims based on real (market) evaluation of risks and their development in time, and the existence of rules to be embedded in laws in the future which will prevent ad hoc decisions undermining public finance development sustainability.

For achieving political consensus for those activities and functions of the state, which should or will be financed from public sources, it is necessary to know the purpose and efficiency of public source spending.

Public finance management reform will thus be focused on three interdependent areas:

- strengthening of public finance transparency
- strengthening of strategic planning for allocation of resources and transition to result oriented budgeting
- creation of a system for establishment of a stable medium term public finance framework

## **2. Public finance transparency**

When strengthening transparency of public finances changes in the following areas have to be made:

### **Application of definition of public administration in practice.**

Presently an amendment to the Law on Budgetary Rules is being prepared specifying entities in the area of public finances. After approval of this amendment, there will be the remaining problem with the Register of state-aided organizations, for which the Statistical Office of the SR is responsible. This is caused by a recent large restructuring of state-aided organizations in connection with transition of competencies to local governments. Due to this it will be

necessary to make an inventory and create a system for updating the register, so that changes are shown without delay. To achieve this status is important not only for a correct specification of public administration, but also for the functioning of the State Treasury, whose clients state-aided organizations are.

Moreover, it is necessary to ensure that all government institutions, but primarily Ministry of Finance, NBS, Statistical Office and State Treasury work with identically specified subjects, so that there are no differences in data reporting to EU, ECB and international financial institutions, resulting from different interpretations of public administration definitions.

### **Budgeting and reporting.**

One obligation resulting from Slovakia's membership in the European Union is to report the fiscal position of the general government according to the ESA 95 methodology. The Ministry of Finance elaborated and implemented a methodology of data transformation, which transforms data reported on a cash base to the ESA 95 methodology (accrual principal). The transformation is a recalculation of aggregate data without a direct link to initial accounting. Therefore, the existing methodology needs to be reflected in the State Treasury system (to be implemented in the near future), which enables to increase the accuracy of reporting and to decrease its administrative demands.

Furthermore, it will be necessary to consider when and in which proportion to move from reporting on accrual basis to implementation of accrual accounting in public administration. This trend is evident in developed countries. Transition to accrual accounting is time demanding and costly and it is irrational to accelerate it without adequate capabilities in the public finance management system to use the data it provides and impossible without a fully functional State Treasury. Therefore a SWOT analysis of transition to accrual accounting in public administration is necessary, after which a decision on the extent and timeframe of its implementation has to be made.

### **State Treasury and Agency for Debt and Liquidity Management**

After many years of project and legislative framework preparation for the State Treasury and the Agency for Liquidity and Debt Management, both institutions began their implementation phases in 2003. The existing cost of both projects and their importance in the frame of public finance management system lead to the conclusion, that it is necessary to give priority to consistency and accuracy over speed. It is important for the State Treasury not only to become a tool for budget execution but also to be an information source for analytical purposes of the Government. In this context it will be necessary to prepare a final elaboration of the relationship between State Treasury, Agency for Debt and Liquidity Management and Ministry of Finance in the area of competencies, methodology, procedures and legislation. The aim is that the Ministry has competencies in policy, targets and goals formulation area and the execution should be the competency of the State Treasury and the Agency.

The implementation plan and risk analysis, due to be completed by the end of May 2003, will determine which State Treasury and Agency functions can be implemented in 2003

and which later on, and which are the needs for additional external support for the building of these institutions. It is necessary to decide, whether, in compliance with the original intention, the State Treasury and the Agency for Debt and Liquidity Management will remain two independent state administration bodies in the form of budgetary organizations, or they will be transformed into independent organizations established on the basis of a special law.

### **Fiscal decentralization and relations to regional self-governments**

In the frame of the public administration decentralization process it will be necessary to resolve all relations between the central government and the state budget with the municipalities' and higher regional units' budgets in the context of decisions about the extent of decentralization on the revenue side (redistribution versus own revenues) and on the expenditure side (purpose bound expenditures versus free application of regional expenditure policy, in compliance with political priorities at this level). Even though deficit and debt problems at the local government level are partially solved in the existing legislation, in the framework for fiscal decentralization it will be necessary to strengthen the enforcement of a hard budget constraint. This should ensure that no unaudited deficits or debts will occur and no extra budgetary and quasi-fiscal activities will exist.

### **Relation to public funds and public institutions.**

The solution of a hard budgetary constraint problem is topical also in relation to social security funds (Social Insurance Company, National Labour Office, Health Insurance Companies) and to other public institutions. In the case of social security funds the question of unaudited deficits is partially solved (these funds have the obligation to discuss their budget proposal with the Ministry of Finance and their budget proposals are afterwards sent for approval to the Parliament together with the Government bill on the state budget), but it does not work this way in the case of other public institutions. The objective of the reform is to achieve that the key parameters characterizing public budget sustainability – deficit (in the ESA 95 methodology net loans/borrowings) and public debt – are fully under the Parliament's control so that the transparency and permanent sustainability principles of public finance development are equally applied in all components of public administration. One of the Government measures will be a change in the National Labour Office field of activity. Active policy of the labour market will be funded from the state budget, what will create a mechanism for the use of co-financing from European funds for support of new job creation. This transformation will create room for decreasing of the current level of contributions to the unemployment insurance system.

### **Extra budgetary and quasi-fiscal activities of the state.**

The scope for extra budgetary and quasi-fiscal activities of the state was significantly reduced in the previous electoral period by reducing the number of state funds and their incorporation into budget chapters (the State fund for liquidation of nuclear equipment and

handling with burnt nuclear fuel and radio-active waste and the State fund for support of housing are exceptions) and by privatization of the banking and „network“ sectors. At present there are the following risks in this area:

- management of the Railway Company and Railways of the Slovak Republic, where financial consolidation is needed and measures are to be adopted in order to prevent additional creation of debt
- management of the Slovak Electricity Company, where problems of existing state guarantees and contingent liabilities need to be resolved
- health insurance system (entire health sector), where the reform needs to be proposed to prevent generation of new debts. The existing debts of the system and the method of its redemption have to be quantified
- granted state guarantees, where not only inventory needs to be done (it does not refer to the „standard“ guarantees provided by the government, which are registered and annually evaluated for risk purposes, but also identification and risk evaluation of a whole range of guarantees provided by the National Property Fund, various state funds, and the risk of guarantees for the Slovak Consolidation Company (taken over from the previous Consolidation Bank for covering working capital loans). The market valuation of recoverability of the realized state guarantees needs to be made, as well as assessment of the risks of non-repayment of outstanding state guarantees and the effectiveness of the claim enforcement system for already realized state guarantees needs to be increased.

Although in the previous electoral period the room for providing state guarantees was significantly limited due to the adoption of Law No. 231/1999 on State Aid as amended later and Law No. 386/2002 on State Debt and State Guarantees, it is necessary to elaborate and implement a system enabling the provision of guarantees only for projects co-financed from international sources, with guaranteed recoverability.

### **Reduction in number of budgetary chapters.**

The state budget presently consists of 49 chapters, half of which represent only 3% of the state budget. This structure of chapters is not effective and increases the administrative costs of the budgetary process. Moreover, for half of the chapters there is not the opportunity to present its objectives and goals in the budget preparation process because they are not directly represented in Government sessions. Therefore it happens that only in the Parliament or its committees' sessions omissions, caused by inefficient communication between the administrators of budgetary chapters and the Government during the budget preparation process, are corrected. For this reason it is necessary that each budgetary chapter is represented at Government sessions on budget preparation.

The reduction of budget chapters requires the elaboration of a mechanism, which should be reflected in the legislation, enabling execution of particular state functions, in

compliance with the Constitution, independent from political power and the existence of independent budgetary chapter.

### **3. Strengthening strategic planning and focus on results.**

One of the main directions in modernization of budgeting in developed countries is a transition to budgeting from top to bottom, based on strategic goals and government priorities in a given period. The aim is to create a system for planning and public finance audit, which will ensure the best outcomes for taxpayers in an environment where demand and supply are to be balanced without the presence of a market mechanism.

Program budgeting is a tool for strengthening strategic planning and management. Program (or result oriented) budgeting links government priorities with budget expenditures. It shows data, which help to improve the effectiveness and emphasises the purpose, for which these resources will be used. It is a system, based on planning of tasks and activities of the Slovak Government in relation to state priorities and disposable resources, oriented on results – such approach increases the effectiveness of allocating budget expenditures.

The goals of program budgeting are:

- To improve the budgetary decision-making process by increasing effectiveness of spending public resources in relation to expected results (effects) and by creating conditions for measuring effectiveness in spending of public resources, e.g. transition from capacity financing to services and goods financing
- To improve responsibility of budget chapter administrators for purposeful and effective spending of funds in the preparatory, implementation and auditing phases of budget fulfilment
- To elaborate a transparent budgetary system, which will allow to assess the purpose and final results of public expenditures

Program budgeting was for the first time implemented in a pilot project for four budget chapters in 2002. For 2003 the number of chapters was increased to nine, and presently all budgetary chapters are preparing program structures for 2004. During the last two years the Ministry of Finance together with the U.S. Treasury advisors have made significant efforts in training line ministries' employees and budget chapters, in order to prepare them for understanding the changes in approach to budgeting and to the acquisition of skills necessary for programme structure creation. Recently the Ministry of Finance published a methodological guideline for programme budgeting, which takes into account experiences acquired during the past two years of the pilot project and integrally incorporates resources from European Structural Funds and Cohesive Funds into the programme structure.

Despite significant efforts in the last two years of the Ministry of Finance and employees from line ministries and other budgetary chapters, the approach to programme

structure preparation and formulation of objectives and goals for particular programmes remains formal and is considered as an additional burden for budget unit employees in ministries. The main reason is that the implementation remained at budget unit employees' level and did not involve managers from professional units nor did it receive attention of political management in ministries. Programme budgeting will become the most important tool for reaching the Government's goals in the area of budget preparation and implementation, which are:

Firstly, to support a managerial approach in the management of individual budget chapters and to extend competencies of a chapter administrator in the reallocation of resources within the limit. The Ministry of Finance will therefore allow the transfer of resources inside individual programmes and binding will be only the limit of resources split in capital and current expenditures and expenditures for wages on the level of the whole chapter. Unspent resources for a programme can be transferred to the next years.

Secondly, to strengthen competition for budget preparation resources. With this intention in mind, part of the assumed budget resources for preparation of the 2004 budget will not be divided by limits to individual chapters, but in the second phase of budget preparation – in August and September – the Government will decide about its allocation, based on priorities and quality of other projects and programmes.

Thirdly, the programme structure allows for the budgeting and spending of resources from European funds within a single budget structure and applies the same procedures for preparation, implementation and evaluation of projects as well as for those elements of programme structure, which are not co-financed from European funds.

Fourthly, a good quality programme structure of a chapter with a realistic estimate of necessary resources on individual levels is an important starting point for the preparation of multi-annual budgeting and the linking of the annual budget through multi-annual budgeting with a medium-term fiscal framework with a forecast of the macroeconomic environment and a top-down approach.

Fifthly, the budget programme structure has an important political dimension and shows the purpose and results of spending taxpayers' money. It is an appropriate tool for the Government's communication with the public.

From 2005 onwards the Ministry of Finance is considering to introduce the programme structure as the primary method for allocating budget resources. Based on the previous experiences, a fully fledged implementation of programme budgeting and the reaching of above mentioned goals will not be possible without a direct involvement of the political management in ministries. This is due to the fact that only on this level it is possible to change the Programme Declaration of the Government, the legislation and priorities of line ministries into identifiable results, which will illustrate public sector competency and effectiveness. Programme budgeting can reach its goal only when it becomes a tool for enforcing political priorities of the Government as a whole and the political management of line ministries.

#### 4. Stable Medium-Term Framework for Public Finances

A medium-term fiscal framework aims at balancing the economic policy and respective expenditure priorities of public budget with macroeconomic constraints reflected in basic parameters of the fiscal domain (see chart 1). )

The medium-term fiscal framework thus sets the medium-term fiscal goals of the government in respect to the key indicators such as total revenues, expenditures, public deficit, public debt and the cost of debt servicing including the identification and quantification of potential risks. In addition, a medium-term fiscal framework should comprise formulation of the medium-term goals for expenditures that are consistent with the goals set out for revenues and the budget deficit as well as their decomposition on the level of expenditure liabilities resulting from the existing and planned activities of the Government.

The goals of the medium-term fiscal framework are set to avoid permanent fiscal stress on the Government and Parliament, to avoid the threat of individual governmental decisions negatively impacting annual budgets and thus ensuring sustainable fiscal development of the country and identify clearly the future fiscal impact of current decisions. From this point of view a stable and trustworthy medium-term fiscal framework is essential for fiscal stabilization, sustainability of macroeconomic stability, ensuring the optimum mix of monetary and fiscal policy and for the transition from passive to active anti-cyclical macroeconomic policy. At the same time it contributes to the stabilisation of the economic environment by creating a transparent basis for formulating medium-term expectations of economic agents. In the context of the pre-accession process, the Ministry of Finance prepared the so-called Pre-Accession Economic Programme to which a medium-term financial outlook, a document submitted to the Parliament on annual basis as an annex to the Bill on State Budget, is linked.

The Pre-Accession Economic Programme has not become a subject of broader political discussion but was understood primarily as a technical exercise. On an annually basis the Slovak Republic, due to its membership of the EU, will have to prepare and update a so-called Convergence Programme. This document is expected to set convergence goals (for accessing EMU) for the medium-term timeframe. It will also comprise a consistent concept of how to achieve these goals. An insufficiently developed system of strategic goals formulation on the political level becomes the first weak spot of the medium-term fiscal framework.

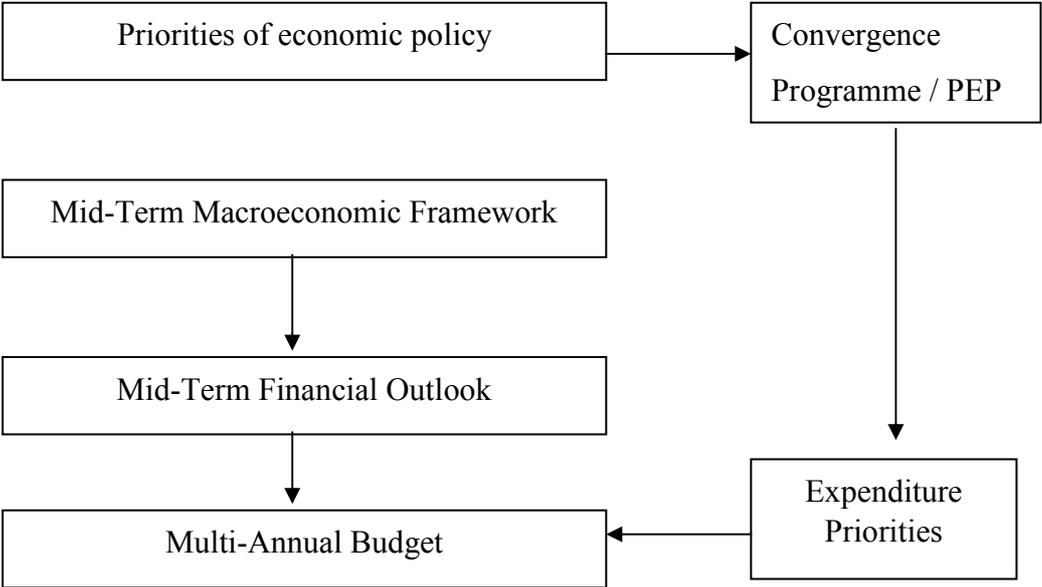
Furthermore, the Ministry of Finance has its own but insufficient methodological apparatus for macroeconomic forecasting. Forecasting of parameters for macroeconomic environment is therefore taken over from several inconsistent sources, which do not enable operative simulations of various options of political decisions in *real time*. Finally, non-existence of a multi-annual budget results in a very weak link between the medium-term outlook and the annual budget.

The transition from a medium-term fiscal outlook to multi-annual budget means defining expenditure goals resulting from multi-annual planning of Government activities and their regular assessment with regard to the effectiveness and purposefulness of the expenditure of public funds. The transition to multi-annual budgeting is therefore conditioned by the real implementation of the result oriented budgeting (programme budgeting). Furthermore, a system linking this to information and procedures used in developing the macroeconomic forecasts needs to be developed for the creation and updating of a medium-term fiscal framework and their incorporation into a medium-term fiscal outlook and consequently into the multi-annual budget parameters. In other words, creation of a stable and realistic medium-term fiscal framework presupposes to:

- create a system of formulation of approval mechanism for economic policy priorities on the political decision-making level;
- create a system of macroeconomic forecasting which provides credible and realistic estimation of future macroeconomic development and ensures a linkage between macroeconomic modules and parameters of public finance domain;
- enhance the system for medium-term fiscal outlook creation that would meet the reporting requirements of the Slovak Republic after EU accession and the needs of domestic decision-making process on the level of the Government and budget chapters;
- create and implement methodology for multi-annual budgeting, including a transparent decision-making mechanism for future Government activities and to them related expenditures.

Financial Policy Institute (FPI) will become a central unit authorised to design macroeconomic forecasts for public administration needs, which public institutions will be obliged to accept. In addition, FPI shall present and defend these forecasts in public. FPI will be responsible for developing outlook documents, which the Slovak Republic, as a member state of the European Union, will be required to develop for the European Commission. FPI and the Budget Policy Section of the MoF will be both responsible for the design of medium-term fiscal framework, while the Budget Policy Section will develop multi-annual budget reflecting (and limiting) expenditure priorities of individual chapters.

**Chart 1 Medium term Fiscal Framework**



**5. Priorities, Sequence and Timetable**

Public finance management reform is a complex process requiring amendment of legislation, as well as the creation of institutional capacities for its implementation. The reform will include an analysis of the budget process, including organisational structure, staff capacities, procedures and decision-making mechanisms within the Ministry of Finance as well as within selected line ministries. The analysis will result in the formulation of recommendations for optimising budget process on all levels and phases.

Public finance management reform comprises a number of interdependent components. It is therefore essential to define a realistic timetable for proposing these components, their implementation and the interlinking of the components that form the integral part – until now they have been prepared separately (e.g. State Treasury Project, programme budgeting, etc.). A Steering Committee, responsible for the supervision of the content and coordination of each component of the reform, was established within the Ministry of Finance and a detailed reform plan for the implementation phase will be designed by the end of June 2003. Nevertheless, the priorities of the next period are clear.

**2003 Priorities:**

- creating conditions for strengthening strategic planning and multi-annual budgeting by extending the programme budgeting to all chapters;
- decision on responsibilities and relations between the State Treasury (ST) and Debt and Liquidity Management Agency (DMA) and MoF of the SR. Building basic functions of the ST and DMA;
- building institutional capacities at the MoF for implementing public finance management reform;
- completing the project of public finance management reform so that implementation phase can start in the second half of 2003;
- creating methodological apparatus for macroeconomic forecasting at the MoF;
- elaboration of an initial version of methodology for preparing multi-annual budget.

**2004 Priorities:**

- further elaboration of programme budget methodology, especially the formulation of goals on particular program levels and the methodology for the evaluation of program results;
- design and implementation of a system for the preparation of a Convergence programme;
- pilot/experimental development of multi-annual budget.

Funding of public finance management reform will be ensured from several sources. The major part of the reform (e.g. result oriented budgeting, methodological apparatus for macroeconomic budgeting, methodology for multi-annual budgeting, accounting, training for State Treasury clients, etc.) will be funded from the loan provided by IBRD (the World Bank) and co-financed from the state budget. This loan will provide funds for technical assistance. The implementation of State Treasury and Debt and Liquidity Management Agency is supported by the PHARE project and a follow up project is being considered. Training activities mainly during the pilot project of program budgeting were financed by USAID, who arranged for technical assistance from specialists from US Treasury.