

Report no. 87944-YF

**The World Bank**

**Republic of Serbia**

# **Municipal Public Finance Review**

## **Options for Efficiency Gains**

**June 5, 2014**

# **Table of Contents**

<b>EXECUTIVE SUMMARY</b>	<b>8</b>
<b>1. INTRODUCTION</b>	<b>1</b>
<b>2. EFFICIENCY GAINS FROM RIGHT-SIZING THE WAGE BILL</b>	<b>4</b>
2.1. Introduction	4
2.2. Regulatory Framework for Local Employees	7
2.3. Are Local Administrations Overstaffed and Overpaid?	10
<b>3. EFFICIENCY GAINS IN UTILITIES SECTOR</b>	<b>21</b>
3.1. Introduction	21
3.2. Performance of PUCs	23
3.3. Impact on Local Budgets	26
3.4. Reasons behind PUCs Inefficiencies	27
3.5. Conclusions and Recommendations	35
<b>4. EFFICIENCY GAINS THROUGH BETTER FINANCIAL MANAGEMENT</b>	<b>37</b>
4.1. Introduction	37
4.2. Budget Planning and Revenue Management	38
4.3. Budget Execution and Control	41
4.4. External Scrutiny and Oversight	46
4.5. Conclusions and Recommendations	47
<b>5. CONCLUSIONS AND RECOMMENDATIONS</b>	<b>50</b>

## List of Tables

Table 1: LG employees, Q4 2013 .....	5
Table 2: Compensation of employees at the local level of government, 2013 .....	5
Table 3: Wage Bill as Percent Total Local Expenditures .....	6
Table 4: Key Legislation Affecting LG Wages .....	7
Table 5: Coefficients for Employees in Direct Administration .....	8
Table 6: Average Gross Salaries of Employed Persons, by Sector and Region (RSD per month).....	12
Table 7: Labor Productivity Indicators, IBNET Water Companies.....	15
Table 8: Services Identified as Utilities by the LCA .....	22
Table 9: Key Indicators of Public Utility Companies 2007-12 (in 000 EUR).....	24
Table 10: Characteristics of Large and Medium PUCs by Sector, 2012 .....	24
Table 11: Top 10 loss makers (2012).....	25
Table 12: Selected Financial Indicators for Large and Medium Sized PUCs (2009-12).....	25
Table 13: Subsidies and other outflows to PUCs as a percent of the local budget .....	27

## List of Figures

Figure 1: LGs Share of Total General Government Expenditures, 2013 .....	1
Figure 2: LGs Share in Total Public Employment, 2013.....	1
Figure 3: Annual real growth rates of the wage bill, in percent .....	6
Figure 4: Ratio Permanent Staff per 1000 inhabitants, Q4 2013 .....	11
Figure 5: Average gross salary per LG employee, October-November 2013 .....	13
Figure 6: Average net wages, by type of employer, 2002-2013, in RSD .....	14
Figure 7: Coefficient average wage in water company/average wage in municipality, 2012 ..	16
Figure 8: Percent change in number of employees in SWM companies average 2011-12 compared to average 2005-08 .....	17
Figure 9: Coefficient average wage in SWM company/average wage in municipality, 2012 .	17
Figure 10: Ratio wage in DHC-total average wage in municipality, 2012.....	18
Figure 11: District Heating Companies Staff Productivity MWh/Staff.....	18
Figure 12: Prices for Public Utility Services and the CPI (December 2006 = 100) .....	32
Figure 13: Water, Sewage, and Wastewater Treatment Prices, 2014 (left scale) and Ratio of Commercial to Household Prices (right scale).....	33

**List of Boxes**

Box 1: International Comparisons .....6

Box 2: Development Directorates and Communal Infrastructure .....29

Box 3: IMF Fiscal Affairs Department (FAD) PFM Assessment 2013 .....39

Box 4: Wage Bill Management Irregularities .....45

Box 5: Main Findings of Audits of Municipal PUCs .....47

## Abbreviations

CPI	Consumer Price Index
EUR	Euro
FAD	Fiscal Affairs Department
FMIS	Financial Management Information Systems
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
LCA	Law on Communal Activities
LGs	Local Governments
LFS	Labor Force Survey
LLSG	Law on Local Self-Governments
LPE	Law on Public Enterprises
LPP	Law on Public Property
MoF	Ministry of Finance
PIFC	Public Internal Financial Control
PPA	Public Procurement Authority
PPP	Public-Private Partnership
PUCs	Public Utility Companies
SAI	State Audit Institution
SWM	Solid Waste Management
WSS	Water Supply and Sewage

## **CURRENCY EQUIVALENTS**

**Currency Unit – 83.9 RSD = 1 US\$**

## **WEIGHTS AND MEASURES**

**The Metric System is used throughout the report.**

## **FISCAL YEAR**

**January 1 to December 31**

Vice President:	Laura Tuck
Country Director:	Ellen Goldstein
Sector Director:	Roumeen Islam
Sector Manager:	Satu Kahkonen
Task Team Leader:	Lazar Šestović

## ACKNOWLEDGEMENTS

This report was prepared by a World Bank team led by Lazar Šestović, Senior Economist (ECSP2) and with the overall support and guidance from Abebe Adugna, Lead Economist (ECSP2). The team comprised (in alphabetical order): Boris Begović, consultant; Aleksandar Crnomarković, Senior Financial Management Specialist (ECSO3); William Dillinger, consultant; Onur Erdem, Young Professional (LCSPS); Lewis Hawke, Lead Public Sector Specialist (ECSP4), and Branko Radulović, consultant.

The team benefited greatly from guidance from peer reviewers Michael Stevens and Min Zhao, Senior Economist (EASPC) as well as from comments and guidance from Sergei Shatalov (Advisor, ECACE), Jonas Frank (Senior Public Sector Specialist, PRMPS), Plamen Kaloyanchev (Economist, European Commission, DG ECFIN) and David Michaud (Senior Water Specialist, ECSUW).

The team is grateful to the Swiss Development Cooperation for their support and comments and suggestions. In particular we are grateful to Gabriela Schafroth (Deputy Director, Swiss Development Cooperation in Belgrade).

The report was prepared under the supervision of Satu Kähkönen, Ellen Goldstein and Tony Verheijen. Its production would not have been possible without excellent support from Anne Grant in editing the document, and Hermina Vuković-Tasić in processing manuscripts and organizing missions. Đorđe Lašić designed covers for the print version.

## Executive Summary

**Serbian public finances are confronting major challenges.** Public revenues as a share of GDP decreased by 2 percentage points while expenditures increased by one percentage point since 2008. In the previous five years the general government deficit averaged 5.8 percent of GDP. Consequently, public debt has more than doubled since 2008; by the end of 2013 it reached 64 percent of GDP. Fiscal policy has been loose for several reasons, particularly the impact of the international economic crisis, slackening public financial management (PFM), and lack of control over some spending categories including the wage bill. Local governments (LGs) have contributed by mimicking the stance of the central government.

**Recognizing that the current path of public debt is unsustainable, the central government is embarking on a significant medium-term fiscal adjustment.** According to the Fiscal Strategy 2014–16, the government goal is to stabilize public debt at about 70 percent of GDP by 2016 and thereafter bring down the debt-to-GDP ratio. To get there, the general government fiscal deficit will be cut from 6 percent of GDP in 2013 to 3.2 percent by 2016. However, success of this strategy requires the coordinated effort of all levels of the government, including LGs.

**The system of intergovernmental fiscal relations has suffered from numerous changes over the previous five years.** There have been many significant changes on the revenue side, most of which were introduced in the middle of a fiscal year (like the reduction in transfers; change in the formula for sharing certain taxes; abolition of some fees and charges). In addition, responsibilities of LGs changed several times, again without prior announcement from the central government.

**LGs will need to adjust both their revenues and expenditures as Serbia goes through fiscal adjustment.** They will need to find ways to perform more efficiently than they currently do as both local and total public spending will have to go down. In addition, more efficient LG spending is important because the projected sluggish recovery of Serbian economy is likely to reduce public revenues. Consequently, revenues that are shared with the central government, such as the personal income tax, and transfers from the central government might go down.

**Lack of corrective measures might put sustainability of local budgets in danger.** The Bank in its 2013 report on local finances<sup>1</sup> stressed that LGs might become part of the deficit and debt problem if no corrective measures are taken. LGs ran deficits between 2009 and 2012 while at the same time the composition of spending worsened – spending on wages increased its share in total while spending on infrastructure decreased.

**This report aims to help both LGs and the Government of Serbia reach the adjustment targets as swiftly as possible.** It identifies specific areas of LG operations that are least efficient and recommends steps to address the inefficiencies. Fiscal savings and additional revenues will depend on careful design of reform policies and actions. Implementing these reforms at the local level will help to resolve some of the problems that Serbian public sector faces for a long time. Therefore, the central government should be supportive of these efforts of LGs to the extent possible.

---

<sup>1</sup> World Bank (2013), Serbia Municipal Finance and Expenditure Review, Phase 1.

**LGs have serious issues related to performance and budgets.** Most obviously, spending on wages has gone up to become the single largest expenditure item; an increasing number of public utility companies (PUCs) have become loss-making and reliant on LG financial support; and irregularities in PFM have increased. These are not issues that characterize only LGs in Serbia, in fact, similar issues appear in all parts of the general government.

**These three issues are interrelated.** LG spending on wages has risen largely because of ineffective PFM systems and weak management and oversight of PUCs. Lack of control over hiring and pay policies and poor financial management have in turn exacerbated PUC inefficiencies. Finally, haphazard implementation of the laws, limited investment in capacity building, and lack of attention from the central government have exacerbated LG PFM problems.

**Addressing these issues could bring significant efficiency gains.** This would include not only balanced budgets but also better service to citizens, more reliable budgeting, less need to borrow, no accumulation of arrears, and more motivated staff. This report, building on previous work done in 2013, suggests that Serbian LGs focus on the wage bill, PUCs, and PFM as the most promising areas for achieving efficiency gains.

### **Efficiency Gains from Rightsizing the LG Wage Bill**

**LGs are major employers.** Their administrations employ about 44,000 people; another 42,000 work in institutions that are funded from LG budgets but organized as separate institutions (indirect budget beneficiaries); and enterprises owned by LGs employ another 77,000. As a result, local employees account for almost 10 percent of all persons formally employed in Serbia.

**Spending on wages is the single largest expenditure item for LGs.** In 2013, it reached 1.6 percent of GDP, accounting for over a quarter of total local budgets. This is the highest share of wages since 2005, when consolidated reporting on local budgets started. Once the cost of labor in local enterprises is added, total spending on personnel reaches 2.5 percent of GDP.

**So far, the central government has been more interested than LGs in restraining the local wage bill** through ceilings on its increases and staffing numbers and controls on the wages of individual staff categories. These regulations have been backed by enforcement mechanisms, of which most important is the reduction in transfers. In addition, the Ministry of Finance (MoF) has influenced the LG wage bill through the budget planning process. The Budget System Law requires the MoF to provide LGs with budget preparation instructions, which include ceilings on individual salary increases and on increases in the total wage bill.

**To keep their budgets under control, LGs need to apply their hiring and pay policies more responsibly** and avoid the numerous regulatory loopholes. One of the most important loopholes is employment within indirect budget beneficiaries, which is currently not bound by the rule on maximum number of LG employees. In addition, the State Audit Institution (SAI)<sup>2</sup> reports that LGs do not strictly follow the decree on coefficients; they introduce new allowances and hire short-term staff even in situations where the legislation prohibits that.

---

<sup>2</sup> All audit reports are made available on the SAI website [www.dri.rs](http://www.dri.rs)

**The total number of permanent staff in local administrations is only slightly above the numeric ceiling set by the central government.** Still, a third of LGs breach the ceiling, which suggests there is significant scope for improvement. Most jurisdictions also exceed the ceiling on temporary staff and short-term consultants (STCs). In fact, hiring temporary staff and short-term consultants has become the main method of circumventing the official ceiling on permanent staff numbers. This group now accounts for one-third of total LG employment. Thus, a parallel hiring structure has been created where rules for hiring and pay and grade are disconnected from the rest of the administration.

**There is a slight wage premium in the public sector.** Other studies that took into account skill levels and educational attainment found a public sector wage premium only for low-skilled workers; there is in fact a wage penalty for high-skilled employees. However, there are regional differences: there is a wage premium in Belgrade, a wage penalty in Vojvodina, and very large wage premiums in the West and South Serbia, poorer regions of the country.

**The evidence of overstaffing in PUCs is compelling.** By the standards of other European countries, both water companies and district heating companies are overstaffed. There is no clear indicator of overstaffing in solid waste management companies (SWMs), although employment there went up by 3 percent during the international economic crisis (2008–12).

**Employees of PUCs in all three sectors covered by this report (water, SWM, and district heating) seem to be overpaid.** This is most obvious in district heating companies, less so in the other two sectors. On average, wages in local PUCs have been above the national average for the economy and higher than in the private sector each year for the past 12 years.

### **Efficiency Gains in Utilities Sector**

**Of the numerous enterprises LGs own, the most important in terms of financial resources, employment, and impact on budgets are utilities.** Serbian LGs own more than 720 enterprises, of which about 350 enterprises are PUCs. PUCs employ 56,200 people—more than 3 percent of all workers formally employed in Serbia. Nonutility local enterprises employ another 20,000 people but have much less fiscal impact. The private sector is allowed to provide utility services, but the vast majority is still provided by PUCs, whose gross value-added is estimated at 2.4 percent of Serbia's GDP.

**PUCs are inefficient and the number of loss-making PUCs is increasing;** the share of loss makers increased from 28 to 48 percent between 2007 and 2012. Consolidated losses stood at EUR 46 million (0.15 percent of Serbia's GDP) in 2012, but in reality this figure significantly underestimates the problem because losses are calculated after subsidies are taken into consideration. Losses are concentrated in large and medium PUCs. These companies accounted for 81 percent of total losses in 2012. In addition, PUCs in general also suffer from chronic liquidity problems, with most of them having difficulty meeting current obligations.

**PUCs receive ample financial support from local budgets, which comes either explicitly as a current or capital subsidy or implicitly through inflated invoices and investments on behalf of PUCs.** In the three largest cities, support to PUCs consumes at least one-quarter of the total budget, and in Belgrade it reaches a third. In 2012, about a quarter of PUCs reported receiving operating subsidies and one-third received capital subsidies. PUCs also receive indirect subsidies

through inflated invoices for the services they deliver to LGs. Finally, LGs provide liquidity support to PUCs throughout the fiscal year, though that is usually repaid before the end of the year and thus is not part of the annual budget execution report.

**Reasons for PUC inefficiency are numerous and often interwoven.** The key ones are lack of clear ownership over assets, poor corporate governance, tariffs too low to cover costs, and unclear division of responsibilities for investments in utilities infrastructure.

**Ownership of assets has long been an issue.** PUCs across Serbia do not own and account for all the assets they use, for several reasons: (1) PUCs have property-related issues with local authorities<sup>3</sup> because LGs rarely transfer the ownership of newly built assets to PUCs. (2) PUCs have issues with the central government because until 2011 all assets belonged to the state, and PUCs were only users of these assets. The process of transferring ownership is moving very slowly. (3) PUCs have problems with owners of buildings that were constructed illegally. Those who financed those buildings also built the necessary utilities infrastructure, which PUCs now use, but who owns it is not always clear.

**PUC management is often heavily politicized.** While there are laws that mandate appointment of PUC managers through transparent and competitive procedures, these are often circumvented so that appointments are shaped by political considerations. LGs also do not adequately monitor their performance. PUCs operate without set criteria and guidelines for monitoring the quality of operations, improving service quality, and financial performance.

**Utility tariffs usually do not cover the cost of investing in and maintaining infrastructure.** As a result, LGs often invest on behalf of PUCs. The investments are usually handled by Development Directorates, separate enterprises established for management of capital projects. This practice creates numerous complications, such as directorates building infrastructure that is not a priority for PUCs and a lengthy process of transferring ownership rights to PUCs. More private participation in the delivery of utility services could help to resolve the problem of insufficient funds for investments. Some transition economies have opted for public-private partnerships (PPPs). Because the experience so far has been mixed, any PPP arrangement needs to be carefully designed.

**The risks to LGs of contingent liabilities arising from inefficiencies in municipal enterprises are significant and should be accounted for and managed.** Their PUCs are accumulating huge losses, yet LGs have no effective oversight authority over them. Consequently, the financial risk to LGs is not adequately assessed and accounted for in budget planning.

### **Efficiency Gains though Improved Public Financial Management**

**After a hiatus in 2008–12, efforts to strengthen PFM systems have picked up.** For example, the number of earmarked revenues has been reduced; numerous extra-budgetary funds have been closed; more effective commitment controls have been introduced; there is now a central registry of public sector employees; and a new public procurement law has been enacted.

**While all levels of government face PFM problems, the problems are most pronounced among LGs,** where capacities are most limited, internal rules and procedures are lacking, and

---

<sup>3</sup> Including Development Directorates.

information technology (IT) systems are not standardized and are inefficient. The agenda for PFM-related reforms is thus lengthy, starting with budget planning and revenue management and covering both budget execution and external controls and scrutiny.

**The current system of LG budget planning and revenue management suffers from numerous problems.** The most important are poor management of revenues; frequent changes in the law and failure to harmonize laws and regulations; excessive central government interference in local budget planning; delays in central government issuance of budget instructions; and the practice of changing the amounts of transfers and shared revenues during the fiscal year.

**Better revenue management could help balance budgets.** LGs need to improve the collection of local taxes and fees. Unfortunately, not all local taxes and fees allowed by law have been introduced, uncollected receivables are high, and some revenues go unrecorded.

**Budget execution is problematic.** Many unresolved issues interfere with LG budget execution: lack of clarity about the legal requirements, especially accounting standards; lack of a unified financial management and reporting system; insufficient capacity for or the complete lack of an internal audit function; inadequate financial management and controls; irregularities in how wages and benefits for LG employees are determined; public procurement irregularities; and difficulties in the management of public property.

**LGs do not have a unified financial management and reporting system.** Local administrations choose accounting and reporting software themselves, and most of it is not only outdated but also not well suited to PFM requirements. Nor do most LGs have an internal audit function, which could improve reporting.

**LGs apply public procurement procedures inconsistently.** Many contracts are awarded without open competition; contracts are signed even though the contract value has not been negotiated and agreed on; and some goods and services are obtained without a signed contract at all.

**Property owned by LGs is systematically undervalued and not fully recorded in their accounts.** Audit reports also indicate that LG equity investments in local enterprises are consistently underreported, which means that the valuation and financial worth of these enterprises is misreported.

**The most positive development is improved external oversight in recent years through the activities of the SAI, private external auditors, and Parliament.** An additional layer of external scrutiny of LGs comes from nongovernmental organizations, which have been progressively building up their monitoring of public finances.

## **Recommendations**

There is clearly significant scope for improving LG finances by concentrating on the wage bill, PUCs, and PFM. Matrix below summarizes short- and medium-term recommendations for addressing inefficiencies in these areas to allow LGs to contribute to the reinforcement of Serbia's public finances.

## Summary of Recommendations

	<b>Reforms and measures</b>	
	<i>Short-term</i>	<i>Medium to long term</i>
<b>Wage bill</b>	<p><b>Central Government</b></p> <ul style="list-style-type: none"> <li>- Regularly publish data on employment within LGs.</li> <li>- Strictly enforce the ceilings on the number of regular staff and short-term employees.</li> <li>- Revise the rule for calculation of severance payments to take into account only years of service with the recent government employers.</li> </ul>	<p><b>Central Government</b></p> <ul style="list-style-type: none"> <li>- Maintain annual budget instructions to LGs which set limits on the overall growth of the wage bill, provide them early in the budget planning cycle and avoid, as much as possible, amending them during the year.</li> <li>- Prepare the legislation on LGs employees (covering base salaries, coefficients, allowances and bonuses).</li> </ul>
	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- Facilitate staff mobility within LGs – offer staff from redundant positions to move to those that have been vacated, or to quit.</li> </ul>	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- Ensure compliance with the wage bill ceilings during budget execution.</li> <li>- Conduct a systematic functional analysis in order to identify functions and positions that could be abandoned or privatized.</li> </ul>
<b>Public Utility Companies</b>	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- Jointly with PUCs, complete assets inventory and improve accuracy of balance sheets.</li> <li>- Jointly with PUCs, prepare grounds for corporatization of PUCs.</li> <li>- Improve the monitoring of PUCs financial performance.</li> <li>- Sign formal service agreements with the management of PUCs.</li> <li>- Jointly with PUCs, publish regularly business plans and annual financial accounts.</li> </ul>	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- Restructure PUCs; where possible, divest their non-core activities.</li> <li>- Promote regional agglomeration of utility services where cost effective.</li> <li>- Encourage PUCs to invest in their own infrastructure; and when LGs undertake such investments, it is recommended to do them through PUCs, not through other bodies on their behalf.</li> <li>- Allow an increase in block tariff in order to provide access to utility services to those with lower living standards.</li> </ul>

	<b>Reforms and measures</b>	
	<i>Short-term</i>	<i>Medium to long term</i>
<b>Public Financial Management</b>	<p><b>Central Government</b></p> <ul style="list-style-type: none"> <li>- Prepare a new legislation defining budget accounting rules.</li> <li>- Jointly with LGs, revise the chart of accounts to fully accommodate the specificity of LGs' operations.</li> <li>- Strictly follow the calendar for issuing budget instructions for LGs.</li> <li>- Publish separate reports on public procurement performance at the local level.</li> </ul>	<p><b>Central Government</b></p> <ul style="list-style-type: none"> <li>- Review financial management and reporting systems currently in use by LGs and support LGs in removing deficiencies.</li> <li>- Consider introducing a certification of budget accountants.</li> <li>- Deliver training and certification program on public procurement for LG staff.</li> </ul>
	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- With the support of central bodies, build capacity of internal audit function.</li> <li>- Jointly with PUCs, improve commitments control.</li> <li>- Jointly with PUCs, strictly abide by the Law on Public Procurement.</li> <li>- Set a firm deadline for completing the assets inventory and improving the management of public property overall.</li> </ul>	<p><b>Local Governments</b></p> <ul style="list-style-type: none"> <li>- Maximize existing revenue-generation potential; decrease the level of uncollected receivables; and properly record and present all revenue receipts in financial statements.</li> </ul>

## 1. Introduction

1. **Since the global financial crisis Serbia's public debt has more than doubled, from 30 percent of GDP in 2008 to nearly 64 percent by 2014.** Public revenues decreased by 2 percentage points while expenditures increased by one percentage point since 2008. The consolidated fiscal deficit averaged 5.8 percent of GDP during the same period – a situation that is clearly unsustainable.

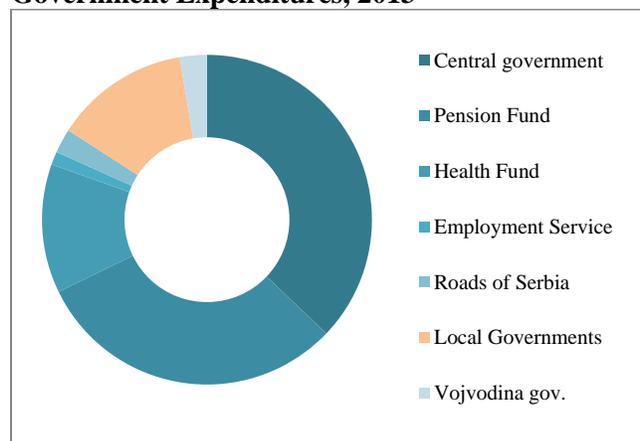
2. **The government recognizes that Serbia must make significant fiscal adjustments, particularly on the spending side** – to reduce debt and divert public finances to a sustainable path over the medium term. Having contributed to the problem to varying degrees, local governments (LGs) as well as the central government will have to share the burden of fiscal adjustment.

3. **The central government envisages a program of fiscal adjustment in the next few years.** According to the recent Fiscal Strategy 2014-16, the government aims to stabilize public debt at about 70 percent of GDP by 2016, after which the debt to GDP ratio is expected to fall. The goal is to reduce the general government fiscal deficit to 3.2 percent of GDP by 2016.

4. **LGs are expected to contribute to this fiscal consolidation effort.** LGs account for about 15 percent of total general government spending, and about 20 percent of total public employment (figures 1 and 2). On average LGs had revenues of 6.3 percent of GDP and expenditures of 6.6 percent of GDP in 2009–13. Therefore, LGs can be expected to contribute to fiscal consolidation by reducing spending and strictly following the fiscal rules set by the central government.

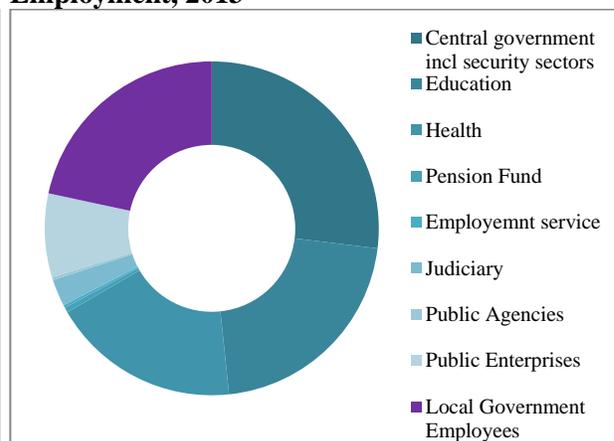
5. **The main question is how and where spending is to be adjusted.** It is clear that LGs need to find ways to perform more efficiently, not only to contribute to national fiscal consolidation effort but also because they may have fewer resources available in future. This is partly because the economic recovery is expected to continue to be sluggish over the medium term, and partly because their share in some revenues, especially the personal income tax and central government transfers, is likely to be smaller.

**Figure 1: LGs Share of Total General Government Expenditures, 2013**



Source: MoF

**Figure 2: LGs Share in Total Public Employment, 2013**



Source: MoF

6. **LGs may find it difficult to become more efficient**, because two major problems depend principally on the central government: (1) the system of intergovernmental fiscal relations is unstable, and (2) the legal framework governing operations of LGs is incomplete.

7. **The system for intergovernmental fiscal relations has changed repeatedly.** After a short-lived period of stability in transfers and shared revenues in 2007–08, there have been many significant changes to the system of inter-governmental fiscal relations, most of which were introduced unannounced, and in the middle of a fiscal year. Among the changes were a central government decision in 2009 to transfer smaller amounts to LGs than the annual budget law had previously envisioned; a change in the formula for distributing revenues from the personal income tax in favor of LGs in 2011 followed by the reduction of this tax in 2013; and elimination of a number of local fees and charges in 2013 and 2014.

8. **Consequently, many LGs have to deal with unpredictable and unstable rules for intergovernmental fiscal relations** that have caused them to either increase borrowing, accumulate arrears, or under-deliver assigned public services. Most worrying is the fact that in the meantime the Law on Public Debt has been amended to allow practically unlimited borrowing by LGs, including through municipal bonds.

9. **As for the legal framework that defines the operations of LGs, because it has been neglected for over a decade, many important segments are still missing.** For example, there is not yet a law governing LG employees, although there have been several attempts to adopt one. The same problem has arisen with laws on local utilities and on budget accounting, among others.

10. **Furthermore, because LGs differ significantly from one another in terms of the duties they perform, their scope for efficiency gains is also likely to differ.** There are 145 LGs, of which 24 are cities. Some cities, such as Belgrade and Niš, comprise several municipalities. LGs perform their duties and responsibilities through direct administration; institutions funded by the budget but organized as separate institutions (indirect budget beneficiaries); and local enterprises. The number, size, and organization of indirect budget beneficiaries and public enterprises differ significantly from one municipality to another—as does the scope for efficiency gains.

11. **Still, there is significant room for LG efficiency gains in at least three areas:** (1) The wage bill is the largest spending category, accounting for about 25 percent of total local spending; (2) Local enterprises impose a significant fiscal burden on LGs: they eat up another 25 percent of local budgets, (3) Management of the resources available to local authorities (local budgets and property) is often inconsistent with sound practices and rules previously set by law, so even existing resources can be better utilized.

12. **The objective of this report is to explore options for efficiency gains in three broad areas: the wage bill; subsidies to and performance of local public enterprises; and PFM.** Not only do the first two categories comprise about half of total LG spending, their issues are interrelated. Options for reforming pay and grading policies have considerable impact on the efficiency gains of local enterprises because the cost of labor is often their largest expenditure category. However, local enterprises shift their losses and inefficiencies to their owners—the

LGs. Sound PFM is noticeably lacking in both LGs and their enterprises. Maximum efficiency gains can be achieved only if all such issues are addressed in an integrated manner.

**13. This report represents a continuation of the World Bank effort to explore LGs finances.** The first phase of this report was published in the spring 2013 and it focused on options for increase in local revenues; impact of further decentralization; options for reduction of subsidies in selected sectors, and how to control the public debt. This report is closely related to the first phase and it provides a more detailed assessment of some of the most important issues identified in the first phase of this work.

**14. The rest of the report is organized as follows:**

- Chapter 2 examines LG hiring and pay policies, asking in particular whether LGs are overstaffed or their staff overpaid. In addition to offering recommendations on how to achieve efficiency and savings, it sheds light on employment and wage policies within LG enterprises, which receive significant funding either as current or capital subsidies from LGs.
- Chapter 3 deepens the analysis of local public utility companies (PUCs), which not only have significant responsibilities for delivering local services but also often pose a significant pressure on LG budgets. On average, financial support to PUCs accounts for a quarter of local budgets. If LGs are to make savings they need to save on PUCs subsidies; this chapter looks into the main issues related to PUCs and makes recommendations for efficiency gains.
- Chapter 4 discusses the most important PFM issues for LGs, asking where better management and accountability could increase value-for-money and help extract additional benefits from current and capital expenditures. The chapter examines budget preparation, execution, and reporting issues as a basis for recommending policies to increase transparency and accountability as well as more efficient use of resources.
- Chapter 5 summarizes the main conclusions and policy recommendations of the report.

## 2. Efficiency Gains from Right-Sizing the Wage Bill

*Since the wage bill is their single largest expenditure category, accounting for about one quarter of total spending, LGs need to explore options for savings related to it. This chapter examines whether LGs are overstaffed, their staff are overpaid, or both. It also sheds light on employment and wage policies within LG-owned enterprises, which receive significant LG funds as current or capital subsidies, thus representing a significant burden on local budgets.*

### 2.1. Introduction

15. **From a regulatory standpoint, local employees fall into three broad groups: employees in direct administration, employees of indirect budget users, and employees of local enterprises.** The wages of the first two categories comprise the LG wage bill. Although wages of employees in enterprises are outside the budget, local enterprises' employment and wage policies are important because LG budgets support them through both current and capital subsidies. Since almost a quarter of LG budgets goes to support these enterprises (see chapter 3), savings on enterprise wage bills could translate directly into savings to LGs.

16. **In the first group are employees and appointed staff in the departments that form part of the LG core administration.** There are 43,800 people in this group (Table 1), which is governed by the Law on Labor Relations in State Bodies and the Law on Salaries in Public Bodies and Public Services; and their wages are more specifically determined by the Decree on Coefficients of Employees in Public Services. There is a ceiling on their size, set as 4 permanent employees per 1,000 inhabitants.

17. **The second group consists of staff employed in institutions funded from the budget but organized as indirect budget beneficiaries.** This group accounts for 42,000 people (Table 1). The most important of these in terms of staffing are preschools, which employ almost 26,000 people. Employees in this group are governed by the same Law on Salaries in Public Bodies and Public Services and their specific wages are determined by the Decree on Coefficients, but there are no ceilings on the number per municipality.

18. **The third group consists of staff employed in municipal enterprises.** These enterprises include mainly companies providing utility services such as water supply, district heating, and solid waste management, though others provide, for example, parking services, media services, and management of conference and sport venues. This is the largest group of local level employees accounting for 77,000 people<sup>4</sup>. Although these companies belong to LGs, their employees are governed by the general Labor Law, which applies to private enterprises.

19. **Together these three groups of employees account for 21 percent of total employment in the Serbian public sector.** LGs employ almost 163,000 people – 23 employees

---

<sup>4</sup> About 33 percent are employed in water companies, about 20 percent in solid waste management companies, 17 percent in public transport companies and about 10 percent in district heating companies. The other 20 percent are employed in a variety of sectors, such as radio/TV, park maintenance, and building maintenance companies.

per 1,000 inhabitants (Table 1). This constitutes almost 10 percent of all formally employed persons in Serbia. Half of local employment is with local enterprises.

**Table 1: LG employees, Q4 2013**

	Permanent staff	Term-staff	Temporary staff	Total	employees per 1000 inhabitants
Local governments' administration	30,477	5,275	8,058	<b>43,810</b>	6
Indirect budget users	33,498	3,616	4,937	<b>42,051</b>	6
o/w kindergartens /1	21,626	3,616	468	<b>25,710</b>	4
Local enterprises /2	66,438	2,833	7,828	<b>77,099</b>	11
<b>Total</b>	<b>130,413</b>	<b>11,724</b>	<b>20,823</b>	<b>162,960</b>	23

Notes:

1. Serbian LGs have established 173 kindergartens, of which 166 submit regular reports to the MoF.

2. LGs have established 722 enterprises, of which about 650 are utilities. MoF collects reports on staffing from 690 of these.

20. **The large number of employees comes with a price tag – the wage bill is the single largest spending category in local budgets.** In 2013, local spending for wages in direct and indirect budget users totaled RSD 56.8 billion (Table 2)—about 25 percent of total spending of LGs<sup>5</sup> and 1.6 percent of Serbian GDP. Once the cost of workers in local enterprises is added, total spending on local employees reaches 2.5 percent of GDP.

**Table 2: Compensation of employees at the local level of government, 2013**

	Total, RSD billion	as %GDP
Local governments	33.4	0.9
Indirect budget users	23.4	0.6
o/w preschools	16.1	0.4
Local enterprises /2	33.5	0.9
<b>Total</b>	<b>90.3</b>	<b>2.5</b>

Note: Staff calculations based on Q4 data.

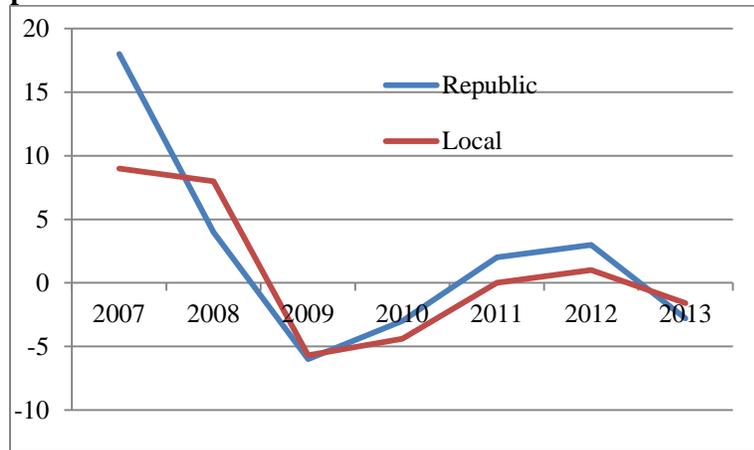
21. **The local wage bill has fluctuated considerably in recent years.** In the two years immediately before the global financial crisis, it grew rapidly: 9 percent (in real terms) in 2007 and 8 percent in 2008. In 2009, in the wake of the international economic crisis, the local wage bill dropped by nearly 6 percent in real terms and in 2010 by another 4.4 percent. This was largely due to a government-imposed freeze on public salaries that went into effect at the beginning of 2009 and remained in place through 2010. Since 2010 wage bill spending has been roughly unchanged in real terms. As shown in Figure 3, these trends closely parallel those at the central level.

22. **As a percent of total LG spending, the wage bill has also fluctuated over the last several years.** As shown in Table 3, the wage bill peaked at 24 percent of total local spending in 2009, declined during the wage freeze, and then peaked at 25 percent in 2013. This makes

<sup>5</sup> It is 14 percent of total spending on personnel of the Serbia general government.

spending on wages the single largest LG spending item. Unless they address the issue of a high and increasing wage bill, LGs cannot keep their budgets sustainable.

**Figure 3: Annual real growth rates of the wage bill, in percent**



**Table 3: Wage Bill as Percent Total Local Expenditures**

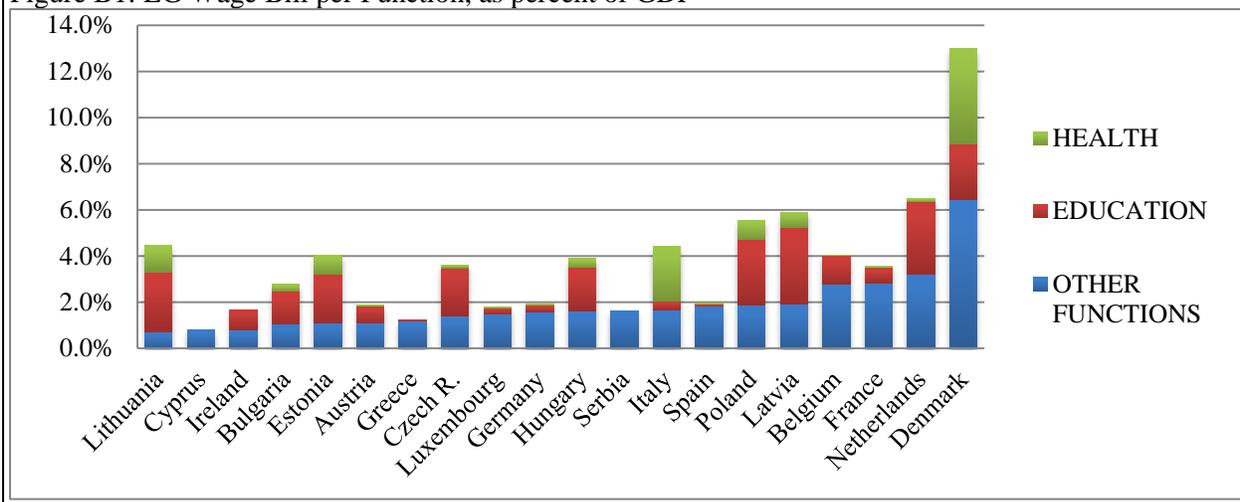
2005	22%
2006	20%
2007	19%
2008	21%
2009	24%
2010	22%
2011	21%
2012	24%
2013	25%

Source: MoF

**Box 1: International Comparisons**

The LG wage bill in Serbia was equal to about 1.6 percent of GDP in 2012. As shown in the chart below (Figure B1), this is considerably lower than in most other European countries. But the size of the local wage bill varies according to the functions assigned to local governments in each country. In countries where local governments pay for teachers' salaries or health care costs, the level of local spending, including on wages, would be expected to be higher than in countries where the central government pays these costs (as is the case in Serbia). The breakdown of municipal wage spending by function shown in the Figure B1 allows more precise comparison among countries. The segments of each bar show the level of local government spending in each country on education, health, and 'other' functions. If spending on the two social sectors is excluded, the level of municipal wage spending in Serbia appears to be fairly typical of EU countries. Serbian municipal wage expenditures are just equal to the median for the group as a whole. Obviously, while some countries can afford this share of spending to go on wages, LGs in Serbia, pressured by the need to save, need to look for options for reducing the wage bill.

**Figure B1: LG Wage Bill per Function, as percent of GDP**



## 2.2. Regulatory Framework for Local Employees

### Legal Framework for Employees in Direct and Indirect Budget Users

23. **According to the existing legislative framework, the size of the local wage bill should be to a large extent controlled by the central government, (Table 4)** which sets out procedures for determining staffing levels and individual salaries and sets ceilings on local staff numbers and wage bill spending as a whole. The basic legislative framework for employees in administration and indirect budget beneficiaries is the Law on Labor Relations in State Bodies. This law sets out procedures LGs must follow to determine the number and rank of positions in each administrative unit and general rules governing recruitment, remuneration, and dismissal.

**Table 4: Key Legislation Affecting LG Wages**

<i>Name</i>	<i>Impact on LG Wage Bill</i>
Law on Labor Relations in State Bodies	Sets the framework for classification, promotion and compensation of LG employees in direct administration
Law on Salaries in State Bodies and Public Services	Sets the framework for calculation of salaries of employees in LG direct and indirect administration
Decree on Coefficients for Appointees and Employees in Public Bodies	Sets coefficients for appointees and employees in direct administration
Decree on Coefficients of Employees in Public Services	Sets coefficients for employees in public services
Law on Maximum Number of Employees	Fixes maximum number of permanent, fixed term and ST consultants
Labor Law (general)	Sets out rights and obligations of employees of LG enterprises
Budget System Law	Sets out central government controls over LG aggregate wage bill in budget preparation and execution

24. **In addition to the generic rules setting out procedures for adding and dismissing staff, the central government attempts to control local staffing numbers directly.** In 2009, Parliament approved legislation setting a ceiling of 4 permanent staff per 1,000 population, which is a target for all LGs. But the law contains a number of loopholes: (1) It explicitly exempts staff employed in preschools and LG enterprises, two of the largest LG employers. (2) It requires less drastic staff reductions in (a) jurisdictions with less than 15,000 inhabitants; (b) jurisdictions that derive less than 20 percent of their revenues from transfers; and (c) jurisdictions where the target would require a reduction in permanent staff of over 20 percent. In all three cases, the number of positions to be eliminated is reduced by 50 percent.<sup>6</sup>

25. **The law envisaged enforcement mechanisms that had direct financial implications.** LGs were expected to achieve the targets for maximum number of employees by the end of

<sup>6</sup> In addition, jurisdictions that must train community police may increase staffing by 2 persons per 1,000 inhabitants. Those jurisdictions with more than one official language may increase their ratios by 1 person per 1,000 inhabitants. Jurisdictions in which refugees constitute more than 2 percent of the population are allowed to include refugees in calculating population. Finally, all jurisdictions may exceed the ceiling if they finance the excess positions from their own resources. The law also sets a ceiling for fixed-term staff, short-term consultants, and other temporary employees of 10 percent of the ceiling for permanent staff.

2009. Jurisdictions failing to do so were to have their transfers from the central government reduced by an amount proportional to the difference between the jurisdiction’s actual staffing ratio and the target ratio. For example, a jurisdiction with a staffing ratio of 8 permanent staff per 1,000 inhabitants (twice the target level) would see its monthly transfers reduced by 4 percent. In the case of fixed-term, short-term, and other temporary personnel, the penalty is considerably smaller: a cut in transfers of 1 percent for every percent the target is exceeded.<sup>7</sup>

26. **National government regulations also largely determine local staff salaries.** The Law on Salaries in State Agencies and Public Services sets out the procedure for setting salaries for local elected officials, appointees, and employees in both direct and indirect administration: Salaries are to be based on a periodically adjusted base salary multiplied by coefficient for each position. The central government base salary is regularly adjusted, normally in April and October. The coefficients are set out in decrees that normally do not change from year to year.

27. **Changes in base salary are determined ad hoc, largely on the basis of macro considerations.** There were large increases in base salary during the relatively prosperous period preceding the economic crisis that began in 2009, at which point the government froze the base salary. The freeze remained in place through 2010, while inflation totaled 17.7 percent for the two-year period. In January 2011, the government raised the base salary by 2 percent, though it nevertheless fell in real terms. In October 2012, the base wage was increased by 5.5 percent, but inflation had shot up to 7.2 percent in the preceding six months. The April 2013 increase was 2 percent and the October increase was another 0.5 percent. While the 2013 adjustments represent an increase in real terms, the cumulative effect between October 2008 and October 2013 was a decline in the base salary of about 18 percent in real terms.

28. **The system of using coefficients to convert the base salary into wage levels for individual positions is complex and in practice (although this should not be the case) differs from one LG to another.** Coefficients for local officials are tied to corresponding central positions and adjusted for differences in costs of living. The decree on coefficients specifies separate coefficients for each of nine ranks, from unskilled worker to independent professional associate (Table 5). The decree sets out the coefficients for employees in public service for the whole public sector, including LGs. The current version sets out coefficients for about 350 different positions, with top-ups for various management positions<sup>8</sup>.

**Table 5: Coefficients for Employees in Direct Administration**

	Base coefficient	Top up		
		<i>Belgrade</i>	<i>Other cities</i>	<i>Municipalities</i>
Professional associates	12.05	16.8	12.6	8.4
Senior associate	9.91	16.4	12.3	8.2
Associate	8.95	11.5	8.63	5.75
Senior staff	8.85	7.19	5.1	3.6
Regular staff	8.85	5.33	4.7	2.3
Senior clerk	8.85	3.03	2.0	1.2
Clerk, typist	8.74	1.85	1.8	0.93

<sup>7</sup> Staff employed in cultural institutions are exempt from this provision.

<sup>8</sup> Directors of preschools, for example, receive a top-up of 20 percent, and assistant directors 10 percent.

Skilled worker	8.00	1.05	1.0	0.53
Unskilled worker	6.40	1.05	1.0	0.93

Source: Decree on Coefficients of Appointed Persons and Employees in State Bodies

29. **In addition to regulating LG staffing procedures and salary levels, the central government controls the local wage bill through the annual budget process.** The Budget System Law requires the MoF) to give LGs budget preparation guidelines at the outset of the budget cycle. In recent years, these have included ceilings on individual increases over the base salary and ceilings on overall increases in the LG wage bill.

30. **There are penalties for jurisdictions that violate the budget instructions.** If the budget decision of a local authority violates the specified wage bill guidelines, the Minister of Finance may temporarily suspend the transfer of funds from the national budget to that jurisdiction until the budget plan is brought into compliance.

31. **To enforce compliance, each LG must submit a monthly budget execution report to the MoF, demonstrating that its wage spending is consistent with the ceiling specified in its budget.** Failure to comply may result in suspension of intergovernmental transfers.

### Legal Framework for Employees in LG Enterprises

32. **For staff employed in LG enterprises, the regulatory framework is much less restrictive.** The central government does not set numerical ceilings on staffing levels or specify rules for determining their salaries. LGs have their own systems of establishment control. Thus local enterprise can decide on increases or reductions in staff members. Employee status, rights, and obligations are determined by the general Labor Law (see also Chapter 3).

33. **According to current law, there should be multilevel monitoring of the wage policy within local enterprises.** The Law on Public Enterprises (LPE) states that each must prepare an annual business plan, which includes projections of salary growth and is submitted to the LG for adoption. Over the course of budget execution, each enterprise must submit quarterly reports on implementation of its business plan to the MoF, the Ministry of Labor, and the relevant line ministry. If the business plan is not implemented in line with the government's wage and employment policies for the public sector, the MoF may temporarily suspend transfers to the enterprise's founding LG.

34. **As a whole, the system of controls over the various elements of the local wage bill would appear to be fairly formidable.** But in practice, it is riddled with loopholes and enforcement is uneven. These shortcomings are discussed next.

### 2.3. Are Local Administrations Overstaffed and Overpaid?

35. **Although central government tries to control staffing and compensation levels, the share of spending on wages in local budgets has risen**, reaching a record 25 percent in 2013. If LGs wish to make savings they need to apply their hiring and pay policies much more strictly. In practice, LG policies have not always been in line with the central government rules.

36. **In recent audits the SAI has identified numerous breaches of the law dealing with the wage bill.** Most drastically, local authorities increase coefficients above the rules set by the decree. They also sometimes increase a base salary and introduce other compensation (bonuses and allowances) that violate the law on salaries for public employees. Finally, short-term consultant contracts are often awarded for tasks that last longer than 120 days and for jobs that should be a regular LG activity (see also Chapter 4).

37. **The analysis that follows first covers staff in direct and indirect administration**, the most important group from the point of view of local budgets because it directly determines the size of the wage bill. This is also an area where direct ceilings on total number of employees apply and where the central government sets maximum increases in salaries. While overstaffing will be checked against the legal ceiling on the number of employees per 1,000 citizens, salary levels are a more difficult issue because of methodological and data problems.

#### *Employment Levels*

38. **A standard approach is to compare staffing levels in one country with those of other countries, but this is difficult to do for Serbia.** Comparisons between countries are difficult because LGs perform different functions in different countries. In Poland, for example, they employ primary school teachers, while in Serbia they do not. Even within Serbia, LG functions are not strictly comparable. Some jurisdictions have vast preschool programs; others do not. Although staffing in the former is presumably higher than in the latter, they cannot necessarily be considered overstaffed—at least not on this basis.

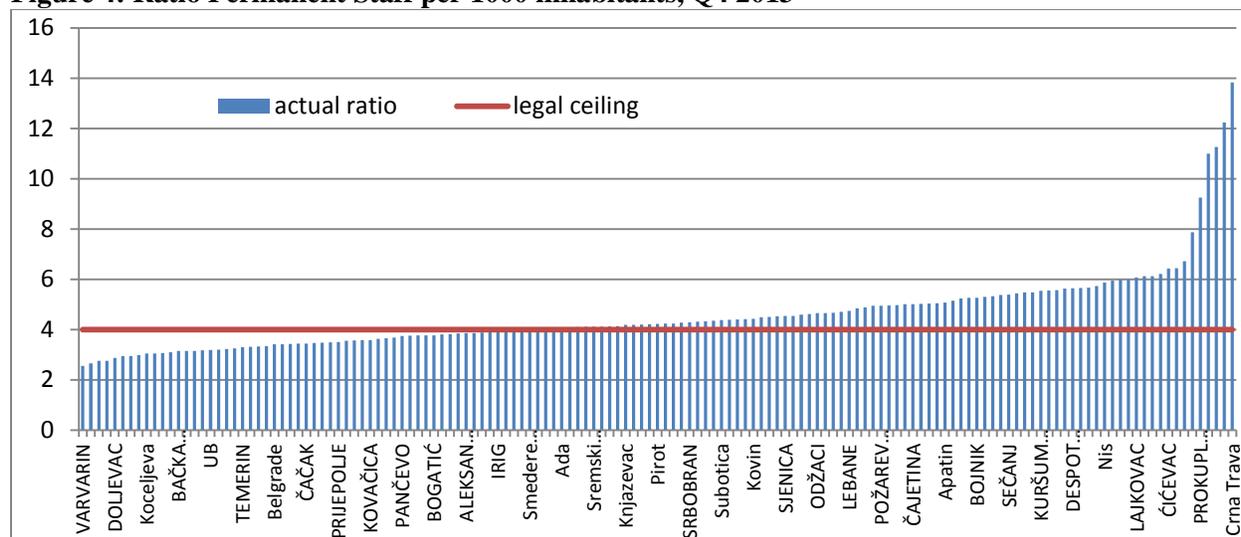
39. **The MoF registry of employees subject to numerical ceilings does provide a basis for comparing staffing levels in direct administration in individual jurisdictions in Serbia.** Since the ceiling explicitly excludes staff employed in preschools, other education or health activities, and municipal enterprises, it removes the principal source of spurious differences.

40. **The total number of permanent staff in local administrations is only slightly above the ceiling set by the central government, but a significant number of municipalities still do not follow the rule.** According to the Law on Maximum Number of Employees at the Local Level of Government all municipalities should have no more than 4 permanent employees in the administration per 1,000 inhabitants. Currently the average is 4.6.

41. **Not only that one third of LGs don't follow the staffing ratio rule, but variations between municipalities are also large.** Figure 4 shows the ratio of permanent staff to the

population in each of the 145 reporting jurisdictions. In two-thirds (87 of 145) the ratio is above 4. LG staffing ratios range from 2.6 in Varvarin to 13.8 in Crna Trava.<sup>9</sup>

**Figure 4: Ratio Permanent Staff per 1000 inhabitants, Q4 2013**



42. **All but 22 jurisdictions have an excessive number of short-term consultants (STC)** if the ceiling (10 percent of the total number of permanent staff) were to be applied strictly.<sup>10</sup> On average there are four times more STCs than there should be; 18 LGs have more STCs than the ceiling for permanent staff per capita.

43. **Hiring of temporary staff seems to be the main way for LGs to avoid the legal ceiling on staff numbers.** Not only is the ceiling on the number of STCs often ignored, the terms on which they are employed, including their level of compensation, is left to the discretion of the hiring manager and governed only by the General Labor Law.<sup>11</sup> In general, the rights and obligations of short-term consultants are governed by the General Labor Law and not affected by the laws governing public sector employment.

44. **The high number of STCs creates distortions in the pay and grading system.** Since STCs account for 20 percent of total local employment and they are governed by the General Labor Law, a parallel structure has been created where the rules for hiring and pay and grading are disconnected from the rest of the administration.

<sup>9</sup> Staffing figures include both permanent and fixed-term staff and short-term consultants. Data are averages for October and November 2013.

<sup>10</sup> This calculation assumes a ceiling of 0.4 fixed-term and STCs 1,000 inhabitants—10 percent of the ceiling on permanent staff, as set out in the law.

<sup>11</sup> According to Serbia’s budget classification system, expenditures on the salaries of ‘temporary employees’ (*plate privremeno zaposlenih*) are classified as wages. But expenditures on contractual services are classified as “goods and services” and are not subject to wage bill ceilings.

## Wage Levels

45. **The most persuasive approach to determine whether LGs overpay staff is to compare LG wages with those of alternative employers.** Ideally, it would be preferable to compare, for any given position, the wages offered by the LG with the wages offered for that position by private firms in the same jurisdiction. This would reveal whether LG wages are sufficient, but only just sufficient, to attract and retain the quality of staff required.

46. **However, there are several limitations to this comparison.** First, jobs in direct administration tend to require relatively high levels of education. Private employment, on the other hand, is dominated by less-skilled occupations. The largest private employers reported by the Labor Force Survey (LFS), for example, were agriculture, manufacturing, and wholesale and retail trade. A second problem arises from the heterogeneity of positions in the public sector. Some positions within the public sector might be overpaid compared to private sector equivalents and others underpaid. A third problem arises from regional variations in wages. Wages prevailing in the private sector vary considerably in different parts of Serbia. As a result, an LG salary that might constitute a wage penalty in Belgrade might constitute a premium in more remote, poorer jurisdictions.

47. **To some extent sectoral data reported by the LFS helps to deal with these problems and it reveals a slight wage premium in the public sector.** The LFS provides wage data on some sectors and activities that are more comparable to those under study. It also provides data by broad geographical regions. If the average wage for private sector jobs that require higher skills is calculated as an average for two categories—“professional, scientific, and technical activities” and “administrative and support activities,” there appears to be a slight wage premium in the public sector. The average wage for the two LFS categories is RSD 62,943 as opposed to RSD 63,248 for the local public sector (Table 6).

48. **Other studies as well show that a public sector wage premium exists, but only for certain types of workers.** A 2011 study (Ognjenovic 2011) found that a public sector wage premium does exist, but only for low-skilled workers. It also found a substantial public sector penalty for higher-skilled (more educated) staff. The study was based on data from the 2007 LFS. Similarly, Laušev (2012), using 2008 LFS data, found a public sector wage premium for low-and mid-skilled employees but not for high-skilled staff.

**Table 6: Average Gross Salaries of Employed Persons, by Sector and Region (RSD per month)**

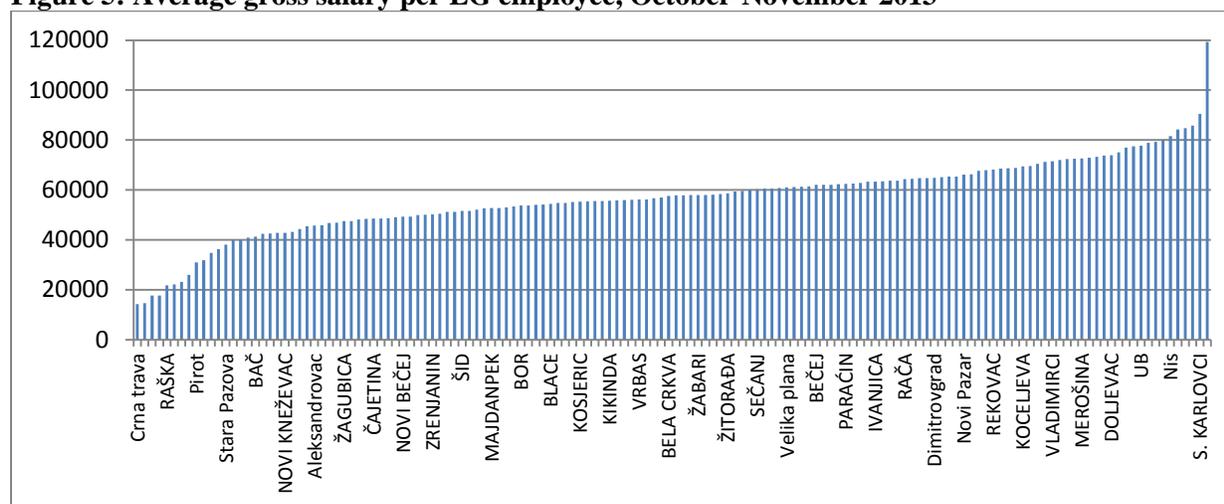
	<b>TOTAL</b>	Belgrade	Vojvodina	Western	Southern
Average of professional and administrative activities	<b>62,943</b>	64,742	73,136	43,977	40,951
Average LG salary	<b>63,248</b>	78,909	62,830	56,222	60,168
Public sector wage premium	<b>0.5%</b>	22%	-14%	28%	47%
<i>Memorandum items:</i>					
Professional and technical activities	82,169	90,261	104,165	43,415	40,529
Administrative and support service activities	43,716	39,223	42,106	44,538	41,372

Source: Labor Force Survey, October 2013, MoF public employee register for October, 2013

49. **There are regional differences in the public sector premium.** If the premium or penalty is calculated by dividing the average wage paid by LGs in each region by the average wage of professional and of support staff in each region, the result is a wage premium in Belgrade, a wage penalty in Vojvodina, and very large wage premiums in the West and South (less developed regions of Serbia).

50. **Variations in average salaries in local administrations among individual jurisdictions are considerable.** As shown in Figure 5, average gross salaries<sup>12</sup> range from RSD 14,304 in Crna Trava to RSD 119,330 in Indjija.

**Figure 5: Average gross salary per LG employee, October-November 2013**



51. **As with staffing levels, LG wage levels may not comply strictly with central government regulations.** The regulations attempt to dictate the base salaries and coefficients of staff in direct and indirect administration but are not always observed. The SAI recently identified numerous breaches, including cases where local authorities increased base salaries or coefficients above the levels set by decrees and introduced other elements of compensation (bonuses and allowances) in violation of the law. The compensation of individual fixed-term staff and STCs is, of course, entirely outside the control of the central government. In this respect, LGs exercise more autonomy than the regulations would suggest.

### 3.4 Are PUCs Overstaffed and Overpaid?

52. **LGs have established a large number of enterprises that are themselves major employers.** These enterprises employ about half of total local employees (77,000) and wage-related spending reaches about 0.9 percent of GDP annually. LG enterprises mainly perform utility services but also a wide variety of other activities. As Chapter 3 demonstrates, of 722 enterprises established by LGs, about 650 are utilities.

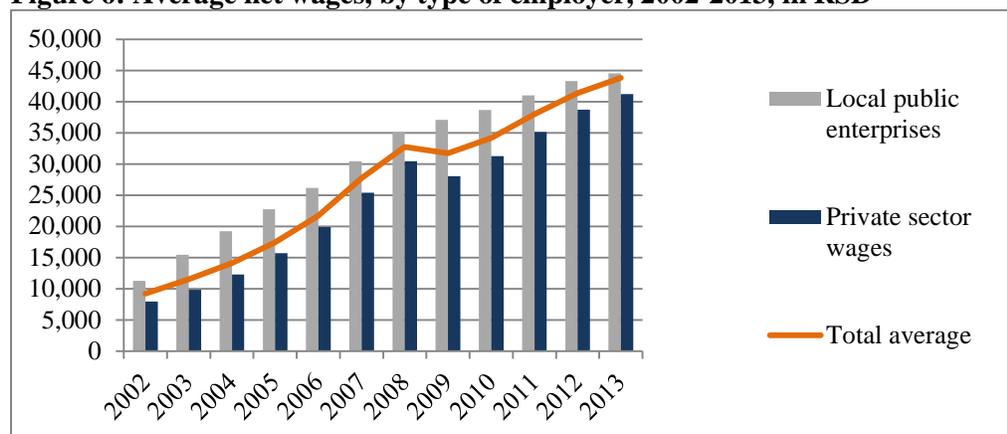
<sup>12</sup> This definition of gross salary refers to Gross (*Bruto*) 2 salary according to the local legislation.

53. **In most cases these enterprises are requesting significant financial support from LGs.** If LGs are to find savings, they will have to reduce that support. A policy of smaller subsidies to local enterprises could be used to justify a request for savings on costs within enterprises, especially labor.

54. **Wages in local enterprises are easier to assess than those in administrations since the type of skills required of their employees is relatively similar to the average required by the rest of the economy.** Unlike administrations, which in general require higher education and specific skills, LG enterprises may be assumed to demand about the same type of skills as other enterprises, so that comparing their average wages with average wages for the rest of the economy gives a solid indication of how salaries match up. To assess overstaffing it is best, wherever possible, to use international comparators and productivity indicators.

55. **On average, wages in local enterprises have been above the national average and higher than in the private sector for at least 12 years** (Figure 6). The gap became most obvious in 2009 when the international economic crisis first hit: private sector wages adjusted abruptly but wages in local utilities kept growing. The data from annual financial statements of enterprises permit more detailed analysis of overstaffing and compensation issues. For purposes of this report, the three largest sectors were analyzed: water supply, solid waste management (SWM), and district heating. Together the three account for two-thirds of the total employment in local public enterprises.

**Figure 6: Average net wages, by type of employer, 2002-2013, in RSD**



Source: MoF

## Water Supply

56. **Serbia has 151 water companies organized as municipal enterprises that employ a total of 18,649 persons.** Comparative data on staffing and compensation levels and the productivity of these enterprises is available in the International Benchmarking Network for Water and Sanitation Utilities (IBNET).<sup>13</sup> IBNET uses a variety of indicators—staff per 1,000 population served, staff per 1,000 connections, labor costs as a percentage of total operating costs—to measure company performance. Regrettably, IBNET has limited coverage in Serbia—

<sup>13</sup> <http://www.ib-net.org/en/>

only 15 municipalities were willing to report to IBNET (Table 7). They include Novi Sad and a variety of small and medium-sized jurisdictions but not large cities like Belgrade or Nis.<sup>14</sup>

**Table 7: Labor Productivity Indicators, IBNET Water Companies**

	Staff Per Thousand Customers	Labor Costs as % Operating Costs		Comparator Countries	Staff Per Thousand Customers
Novi Bečej	0.3	39		Slovakia	0.5
Horgoš	0.4	46		Poland	0.6
Bač	0.5	21		Czech Rep	0.6
Bečej	0.9	56		Hungary	0.9
Novi Sad	1.0	41		Serbia	1.4
Negotin	1.2	58		Romania	2.0
Svilajnac	1.2	51			
Vrbas	1.3	54			
Novi Pazar	1.3	59			
Sjenica	1.5	60			
Sremska Mitrovica	1.5	39			
Kladovo	2.0	61			
Rača	2.7	72			
Leskovac	3.9	68			
<b>Average</b>	<b>1.4</b>	<b>52</b>			

Source: IBNET. Data for Serbian companies is for 2011. Data for the Czech Republic, Poland, and Romania is for 2010. Data for Hungary and Slovakia is for 2007.

57. **Most Serbian companies surveyed by IBNET in Serbia seem to be overstaffed, though there is considerable variation**, from 0.3 staff per 1,000 in Novi Bečej to 3.9 in Leskovac (Table 7).<sup>15</sup> The average for IBNET companies in Serbia is 1.4 staff per 1,000 customers, while the average for Slovakia is only 0.5, for Poland and the Czech Republic 0.6, and for Hungary 0.9. The only country with more staff per 1,000 customers is Romania.

58. **This conclusion is subject to several caveats.** There are, for example, problems with the comparability of companies. Some companies within Serbia provide sewerage as well as water supply and therefore require more employees per customer. Some rely on contractors more than others. (Belgrade for example, has a separate company that handles billing for all the city's utilities.) Nevertheless, the wide variation in staff productivity indicators among companies within Serbia, as well as high levels of staffing than in neighboring countries, suggest that some companies have more staff than necessary.

59. **There are huge variations in wages and a policy of continuous wage increases.** Data from annual financial statements show considerable variation in average wages, measured as personnel expenditures per employee. The average wage paid by the water company serving Vlasotince, for instance, is about three times higher than in Dimitrovgrad. On average, in 2012

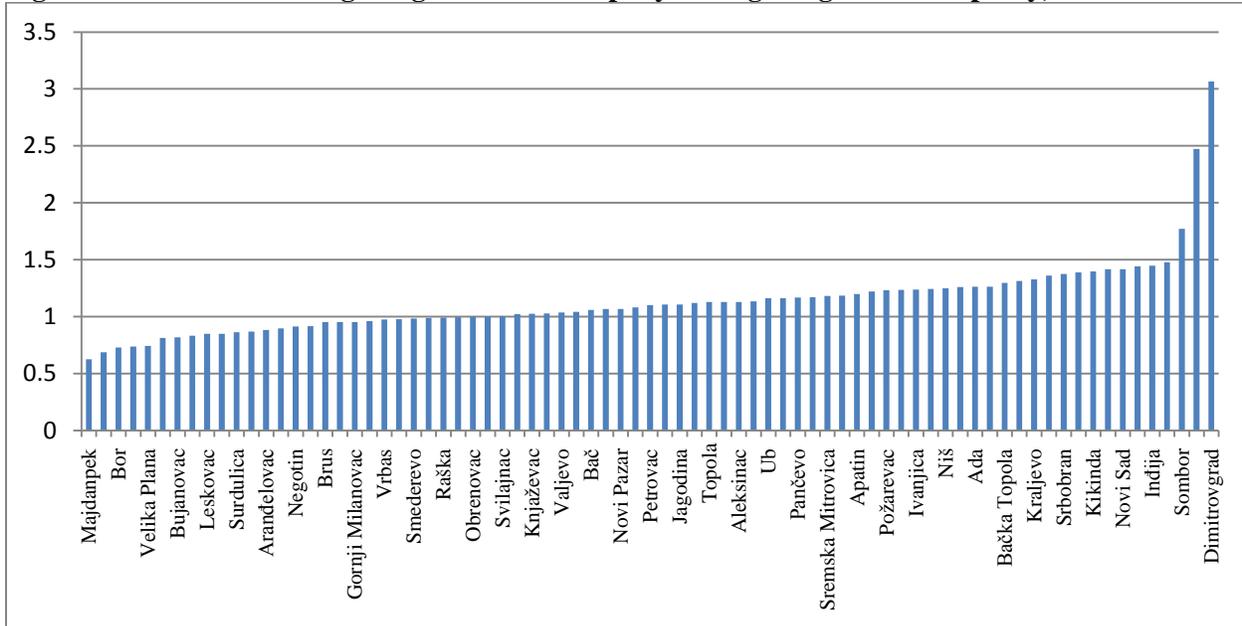
<sup>14</sup> The IBNET data also includes Subotica, but it is excluded from the analysis because its data are implausible.

<sup>15</sup> The staff-to-customer ratio for Belgrade can be roughly estimated at 1.8, based on a city-center population of 1.344 million and staff of 2,396 (from the company's 2013 business plan).

salaries in Serbian water companies went up by 8.9 percent; wages went down only in Nis (–4 percent) and Belgrade (–1 percent).

60. **Workers in most water companies are probably overpaid.** In 51 (of 77) water company wages were higher than the average for the economy of the municipality where they operate (Figure 7). On average, wages in water companies were 27 percent higher than the average for the municipality (2012 data); in 28 of the 77 companies, the average wage was above the national average.

**Figure 7: Coefficient average wage in water company/average wage in municipality, 2012**

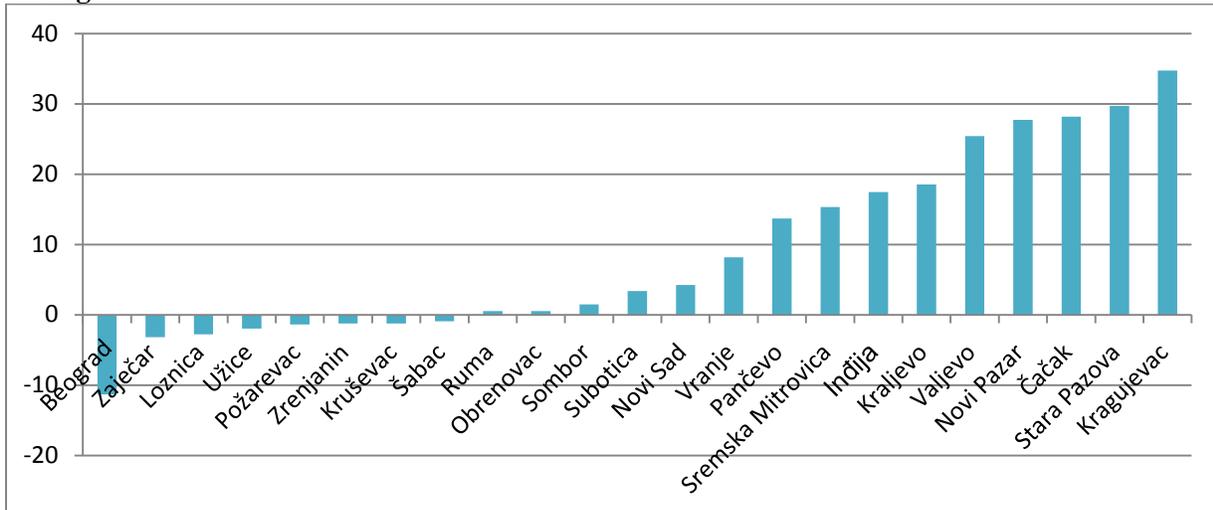


Source: MoF

### Solid Waste Management (SWM)

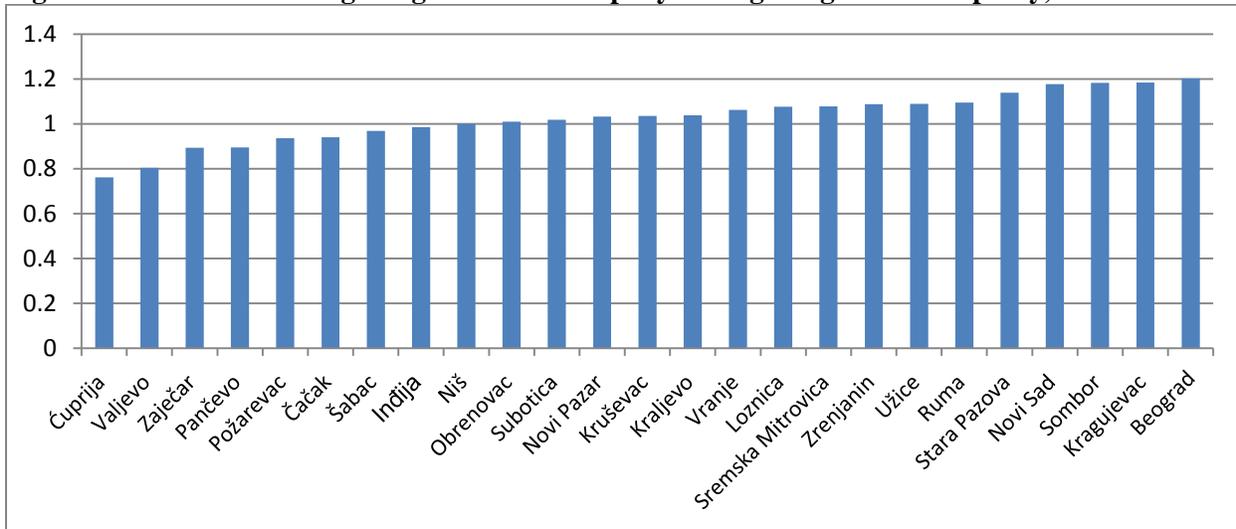
61. **Any overstaffing in SWM companies is not obvious, although SWM employment went up 3 percent during the crisis.** Data on employment, available for only 23 SWM companies, show that the number of employees in 2011–12 was 3 percent higher than the pre-crisis average in 2005–08, though 8 of the 23 did cut staff. Figure 8 shows the change in number of employees in most recent years compared to before the crisis.

**Figure 8: Percent change in number of employees in SWM companies average 2011-12 compared to average 2005-08**



62. **Employees of SWM companies are probably overpaid.** In 17 of 25 companies the average wage is higher than the average for the municipality in which they operate. Wages in these enterprises averaged 10 percent more than the municipality average in 2012 (Figure 9). In addition, all SWMs increased wages in 2012, ranging from 1 to 16 percent.

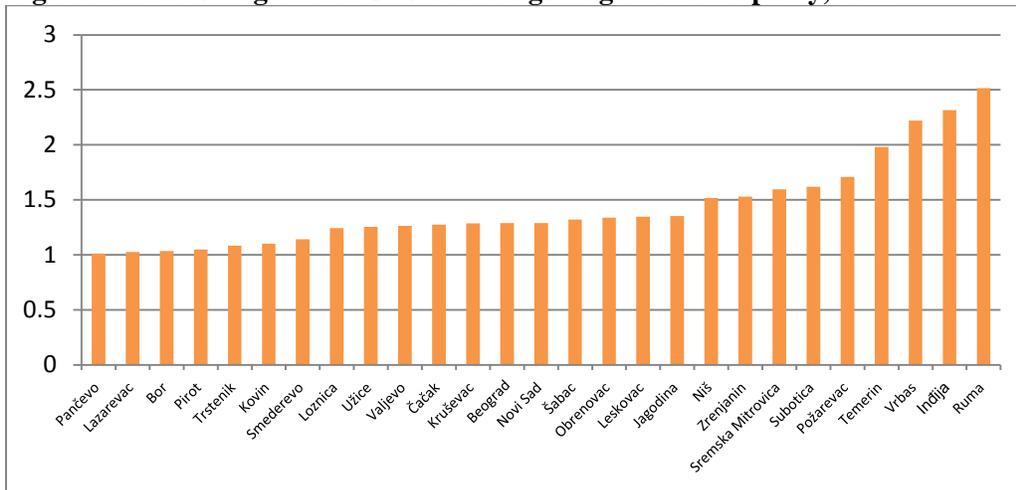
**Figure 9: Coefficient average wage in SWM company/average wage in municipality, 2012**



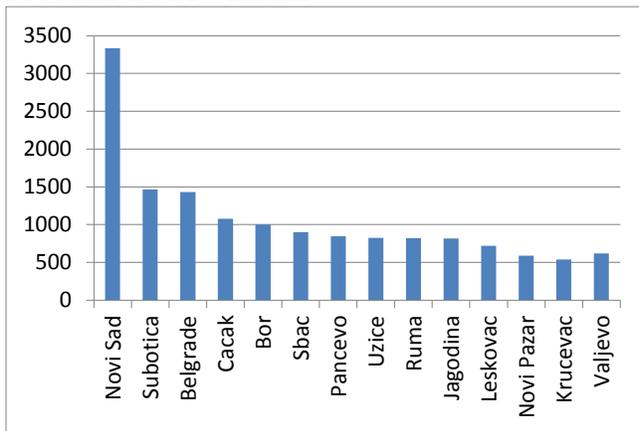
## District Heating

63. It is most obvious that employees in district heating companies (DHCs) are overpaid. In all of them for which 2012 financial statements are available, the average wage was higher than the average for economy in the municipality in which they operate<sup>16</sup> (Figure 10).

**Figure 10: Ratio wage in DHC-total average wage in municipality, 2012**



**Figure 11: District Heating Companies Staff Productivity MWh/Staff**



production possibilities: modern DHCs in EU15 states typically produce about 10,000 MWh per employee.<sup>17</sup>

64. The data also suggest that DHCs are overstaffed. One indicator of excessive staffing is the amount of heat produced per employee: low ratios indicate excessive staffing. Figure 11 shows the ratio of heat produced per employee for the 14 companies. Novi Sad is by far the most efficiently staffed company in the sample, producing 3,334 MWh per employee, over three times the average for the sample as a whole. Belgrade, in contrast, produces only 1,433 MWh per employee and Valjevo only 619 MWh. But even Novi Sad is far behind the

<sup>16</sup> District heating services are largely confined to residential and commercial consumers in large Serbian cities. There are about 60 DHCs, some of them have multiple functions or are part of other enterprises. About 40 DHCs have as a core activity district heating only.

<sup>17</sup> The differences, particularly in staff productivity, between companies in Serbia are partly explained by technology: modern heating plants are less labor-intensive than older ones. It is also explained by the scale. Novi Sad, for example, has much larger plants than smaller jurisdictions. Density and fuel choice are also factors. Low-

### 3.5 Conclusions and Policy Recommendations

65. **Wages are the single largest expenditure item for LGs.** In 2013, spending on wages by direct and indirect budget users accounted for one-quarter of total local budgets (1.6 percent of GDP). So far, the central government has been more interested in restraining the local wage bill than LGs are. The central government has introduced several tools for limiting escalation in local wage bill.

66. **However, the regulations are full of loopholes.** Most important, the MoF has never sanctioned an LG that has breached the law by reducing transfers, even though the SAI in its reports has identified numerous breaches of the wage bill laws.

67. **The total number of permanent LG administrative staff is only slightly above the ceiling set by the central government, but about a third of municipalities still do not respect the ceiling.** Most jurisdictions also exceed government limits on short term consultants. Hiring temporary staff has been the main way LGs avoid the legal ceiling on staff numbers.

68. **Local administrative staff are probably slightly overpaid.** In general there is a small premium for LG employees, more obviously for low-skilled workers. Here again there are regional differences: the highest public sector wage premiums are in the West and South Serbia, poorer regions of the country.

69. **The evidence of overstaffing and overpayment in municipal enterprises is more compelling.** Employees of PUCs in all three sectors covered by this report (water, SWM, and district heating) seem to be overpaid, most obviously those in DHCs. Also, by the standards of other European countries, both water companies and DHCs seem to be overstaffed.

70. **Even if Serbian LGs were not systematically overstaffed or overcompensated, current economic conditions suggest a need to seize every opportunity to reduce excess staff and curtail wages.** The remainder of this chapter provides recommendations on measures and reforms that LGs and the Serbian government could consider implementing over the short and medium term.

#### *Short-term Measures*

71. **In the short term, the government should work to tighten controls over new hiring.** It should close staffing loopholes and, as the law envisages, penalize violations, in particular those related to short term consultants.

72. **The government should continue to set base salaries and coefficients and use its authority to limit local salary increases.** Efforts to ensure compliance should be stepped up, along the lines suggested by SAI reports.

---

density service networks require more maintenance staff than networks that serve more compact areas. Coal-fired burners (as in Bor) require more staff than burners fueled by natural gas or heavy fuel oil. But the variations in staff productivity among companies with similar production characteristics suggest that some are overstaffed.

73. **The central government needs to systematically implement the wage bill rules that it sets.** MoF is not sanctioning breaches of rules by LGs. Although it has a powerful tool to prevent breaches, it apparently has never used it. It might be advisable for the MoF to make an announcement once it is ready to reduce transfers as a corrective measure. Finally, the central government can increase penalties for exceeding the ceilings on staffing numbers, in particular for short-term staff.

### *Medium-term Policies*

74. **In the medium to long run, a better approach would be to rely less on micro controls and more on macro controls:** That would mean imposing a hard budget constraint on each LG and then allowing each LG to decide how best to spend its resources. For this to happen, Serbian government and Parliament need to respect the system of intergovernmental relations set by law. The government and Parliament have repeatedly failed to abide by the system they put in place in 2007. If Serbian LGs must confront a hard budget constraint, the fiscal rules will have to be more stable.

75. **The government could also help LGs to downsize.** Downsizing efforts need to be based on systematic analysis of staffing needs. At the macro level, the analysis could look at the functions performed by the LG to identify those that could be abandoned or privatized.

76. **While the legal impediments to downsizing are not too formidable, downsizing can be difficult and expensive to implement.** Employers must pay severance, which could be costly since the amount is now based on the number of years individuals have been employed throughout their lifetime. The government might therefore consider revising the rules on severance. It could also finance technical assistance and facilitate inter-municipal exchange of experience.

77. **Alternatives for LGs are to rely on voluntary separation or attrition—**providing financial incentives for staff to leave on their own accord or waiting for them to retire and then not replacing them. Each approach has advantages and disadvantages. Voluntary separation is expensive and is particularly vulnerable to adverse selection, the risk that the best staff will choose to go. Attrition, though less costly, is slow.

78. **In the long run, the government can also move to facilitate more rational staffing and wage policies at the local level.** This could be part of the broad government effort to pursue pay and grading reform across the public sector.

### 3. Efficiency Gains in Utilities Sector

*LGs deliver most of their services through specially established local enterprises. Half of these provide utility services (“public utility companies,” PUCs). Local enterprises and PUCs in particular, often put considerable pressure on local budgets. LGs give them direct and indirect financial support through such vehicles as subsidies, investments on their behalf, short-term loans, and special service agreements. On average, financial support to PUCs of all types accounts for a quarter of local budgets, yet in 2012 the net losses of all Serbia’s PUCs combined still reached €46 million. The fact that almost half of all PUCs lose money suggests that their inefficiencies are huge. Financial support to PUCs could be an area where LGs might save. However, for that to happen, PUCs need to become more efficient. Reducing financial support could be a useful incentive for them to accelerate restructuring. This chapter looks into the main PUC issues and makes recommendations for efficiency gains.*

#### 3.1. Introduction

79. **LGs own numerous enterprises; of these, utilities are the most important in terms of financial resources, employment, and impact on LG budget.** LGs in Serbia own over 720 enterprises, about 650 of which have the legal form of public enterprises. About 350 of these formally deliver utilities services.<sup>18</sup> Among those that are not utilities, the most important are about 140 development directorates and urban planning enterprises.<sup>19</sup>

80. **The area of public utilities is regulated by a myriad of laws and regulations.** According to the Law on Communal Activities (LCA) and the Law on Local Self-Government (LLSG), local authorities are responsible for regulating and setting conditions for permanent performance and development of public utility services. Their operations must also adhere to the laws governing public companies, public property, public-private partnerships (PPPs) and concessions, and public procurement, plus a number of sector-specific laws<sup>20</sup>.

81. **The LCA identifies 14 utility services** (Table 8). However, the list is not exhaustive. The LCA allows local authorities to “define other activities of local interest and prescribe the conditions and manner of their performance.” Thus it is possible for utilities to cover not only such services as public baths, sports centers, and maintenance of public wells and fountains but also any other activity proclaimed to be of local interest.<sup>21</sup> Of 353 PUCs, 151 have as their

---

<sup>18</sup> For example, the city of Belgrade has 12 PUCs and 9 other public enterprises and the city of Kragujevac has 7 PUCs and 8 other public enterprises.

<sup>19</sup> While at least some portions of all PUC financial statements are publicly available, those of directorates and urban development enterprises are not, because they do not submit statements to the Business Registration Agency.

<sup>20</sup> Including the Law on payment deadlines.

<sup>21</sup> Natural gas distribution is not explicitly listed as a communal utility service, yet a number of PUCs operate as distributors of natural gas.

primary business activity water supply and sewage, 62 waste management, and 41 district heating.<sup>22</sup>

**Table 8: Services Identified as Utilities by the LCA**

Utility services	Utility services of general economic interest <sup>23</sup>	Private sector participation limited (Art. 5 LCA)
1. Water supply	✓	✓
2. Rainwater and wastewater treatment and discharge	✓	
3. Heating energy production and distribution	✓	
4. Communal waste management	✓	
5. Public transport in urban and suburban traffic		(✓)
6. Cemeteries management		(✓)
7. Public parking lots management		
8. Maintenance of public lighting		
9. (Open) markets management		
10. Maintenance of streets and roads		
11. Maintenance of cleanliness in public areas		
12. Maintenance of parks and recreational areas		
13. Chimney sweeping services		
14. Zoo hygiene services		

82. **The private sector is allowed to provide utility services, but its market share is negligible.**<sup>24</sup> The LCA states that “communal utility services may be offered by public enterprise, commercial company, entrepreneur or other economic entity,” thus officially removing preferential treatment for local PUCs. Only for water supply and to some extent public transport networks are there legal barriers to private entry, because the LCA (Article 5) allows only PUCs or companies in which the Republic of Serbia has a majority stake to provide these services.

83. **Provision of utility services<sup>25</sup> is formally based on contracting-out, a time limited contract between local authorities and the PUC operator.** Contracting-out is based on a decree of the LG and a signed entrustment contract. The procedure differs depending on whether the operator has the right to collect fees, in which case the procedure is governed by the Law on Concessions and PPP, or the services are financed by the local budget, in which case the Law on Public Procurement governs. However, often there are no written contracts at all.

<sup>22</sup> According to the NACE classification of activities.

<sup>23</sup> Most of the local infrastructure related activities (natural monopolies with substantial sunk costs) are being treated as activities of general economic interest. The Law on Consumer Protection defines that activities of general economic interest cannot use any form of price discrimination and prices have to be cost based. Furthermore, the law sets the limits on the cessation of provision of utility services.

<sup>24</sup> With respect to private sector involvement, the main exceptions have to do with maintenance of streets and roads, public transport, management of public parking, and natural gas distribution. A number of companies that maintain roads are private, because they were previously “socially owned” and have been privatized since the early 1990s. Several cities, like Belgrade, awarded service contracts for public transportation to qualified private companies that submitted the best bids. With respect to parking lots several smaller cities (e.g., Svilajnac and Jagodina) have established joint ventures with private sector companies. Several such PPPs also distribute natural gas.

<sup>25</sup> Except for the water supply and public transport.

84. **PUCs are organized in a variety of ways.** While a number of PUCs have rather simple organizational structure and cover just one type of activity, some are both technologically and organizationally complex, combining several utility services (multiservice PUCs). Multiservice PUCs are usually located in small cities and municipalities, where they provide services in often unrelated sectors (e.g., solid waste removal and open markets), mainly because of economies of scope.

85. **Local utilities in Serbia are almost exclusively managed by an individual municipality.** Inter-municipal cooperation in the delivery of utility services is still rare. Only as of recently there have emerged a few regional PUCs, especially for landfills, water supply, and public transportation.

86. **PUCs employ about 56,200 employees, of which almost a third work for 12 Belgrade PUCs.** PUCs employ more than 3 percent of all formally employed Serbian workers. Nonutility local enterprises employ another 21,000. In all, local enterprises employ about half of all LG employees.

87. **At the end of 2012 total PUC assets were around EUR 3.1 billion, about 10 percent of GDP.** However, the quality of PUC balance sheets is questionable; they suffer from both improper assets valuation and incomplete inventories. In some cases the main assets—communal networks or their components—are presented in the balance sheets of the LG itself, in others in the balance sheets of other public enterprises, such as development directorates.

88. **The contribution of PUCs to the Serbian economy as a whole is significant.** Gross value-added of all PUCs is estimated at EUR 707 million, 2.4 percent of GDP. For PUCs, average gross value-added per worker for large and medium-sized PUCs in 2012 was estimated at about EUR 10,600, somewhat below the average for the whole enterprise sector (about EUR 13,000).

### 3.2. Performance of PUCs

89. **PUCs generally operate inefficiently: the net losses of all PUCs combined reached about EUR 46 million in 2012.** Total operating revenues of PUCs were EUR 1.3 billion in 2012 (about 4.3 percent of GDP), of which almost half went to Belgrade PUCs. Although in 2012 195 PUCs had net profit (about EUR 15 million), 158 showed net losses (of EUR60 million), thus leading to a consolidated net loss for the whole sector of EUR 45.6 million. These are net losses after subsidies from LGs are taken into account.

90. **The number of lossmaking PUCs has increased by 70 percent since 2007.** While reported aggregated net losses fell between 2007 and 2012 (from EUR 72.2 million in 2007), the number of loss-making PUCs went up significantly (Table 9), from 28 to 48 percent. The decrease in aggregate losses is mainly due to the improved results of water supply and district heating PUCs even as more multiservice PUCs began to record losses. Aggregate losses probably went down because prices that they charge rose (see section 3.3).

**Table 9: Key Indicators of Public Utility Companies 2007-12 (in 000 EUR)**

Year	Total Assets	Total Capital	Operating Revenues	Net profit	Net Loss	Aggregated Net Profit/Loss	Number of PUCs	Number of PUCs operating with net profit/loss	Number of employees
2007	3,402,014	2,660,105	1,188,301	26,658	98,836	(72,178)	324	232 / 92	n.a.
2009	3,091,323	2,182,491	1,138,768	30,114	63,364	(33,250)	339	195 / 144	55,896
2010	2,985,298	1,911,595	1,151,267	14,303	61,631	(47,328)	346	209 / 137	55,798
2011	3,242,695	1,978,640	1,300,780	18,103	72,083	(53,980)	351	212 / 139	55,389
2012	3,110,390	1,825,712	1,274,172	14,172	59,761	(45,589)	353	195 / 158	56,184

Source: Authors' calculation based on financial statements

91. **Losses are concentrated in large and medium PUCs**, which accounted for 81 percent of total losses in 2012 (Table 10). These PUCs are loss-makers in all sectors except district heating. Public transport companies had losses of EUR 18.5 million, while district heating and gas distribution companies had a combined profit of EUR 3.1 million.

**Table 10: Characteristics of Large and Medium PUCs by Sector, 2012**

Sector	Number of PUCs	Total Assets (EUR)	Employees	Net Profit /Losses 000 EUR	Value Added per worker (EUR)
District Heating and Natural Gas	29	228,112	1,682	3,122	17,339
Public Transport	6	210,258	8,497	-18,548	8,451
Water Supply and Sewage (WSS)	38	1,376,495	10,411	-3,859	10,779
Solid Waste Management (SWM)	6	73,811	3,463	-604	9,110
Multi-service - WSS plus other utility services	40	179,943	6,579	-8,031	7,924
Multi-service - SWM plus other utility services	21	62,040	5,590	-674	8,341
Other	35	366,305	9,925	-8,470	10,124
<b>Total Large and Medium Sized PUCs</b>	<b>175</b>	<b>2,496,964</b>	<b>46,147</b>	<b>-37,067</b>	<b>10,634</b>
Share of Large and Medium Sized PUCs in Total for all PUCs	50%	82%	82%	81%	-
Total PUCs	353	3,041,021	56,370	-45,589	-

Source: Author's calculations based on the data from the Statistics Office and Agency for Business Registries.

92. **Losses are concentrated in several large PUCs**. Combined, the top 10 lossmaking companies had 35 million euros of losses (Table 11), of which EUR 18 million was attributable to the Belgrade Public Transport Company (GSP Beograd). Losses as reported in final accounts are actually underestimated because they are calculated after subsidies are taken into consideration. Though about 20 PUCs are technically insolvent, as yet only a handful are in insolvency proceedings.

**Table 11: Top 10 loss makers (2012)**

COMPANY	Sector	City/Municipality	(EUR mln.)
PUC Gradsko saobraćajno	Public transport	Belgrade	18.2
PUC Beograd-put	Public roads	Belgrade	6.7
PUC Standard	Water supply, sewage and other utility services	Jagodina	3.2
PUC Lazarevac	Water supply, sewage and other utility services	Lazarevac	2.3
PUC Put	Public roads	Novi Sad	2.3
PUC Gradska toplana	District heating	Kruševac	1.3
PUC Energetika	District heating	Trstenik	0.9
PUC Toplana	District heating	Kikinda	0.8
PUC Čistoća	Waste	Novi Sad	0.8
PUC Vodovod	Water	S. Palanka	0.8

Note: After subsidies are taken into account. Source: Authors' calculation.

93. **Liquidity is a chronic problem.** A very low current ratio (current assets/current liabilities) indicates that most PUCs may be having difficulty meeting current obligations (Table 12). Liquidity ratios for PUCs that rely largely on user charges are even worse. On one side, PUCs must pay suppliers within 45 days to avoid violating with the Law on Payment Deadlines.<sup>26</sup> On the other side, they have very low collection rates. A new enforcement mechanism for nonpayers is, at least according to PUCs, not yet cost-effective and there is very high uncertainty about collection.<sup>27</sup> In large cities (Belgrade, Novi Sad, Niš, and Kragujevac) utilities outsource collections to a separate PUC created solely to issue invoices and collect payments, but again timely collection is difficult.<sup>28</sup> Public institutions and large non-privatized enterprises tend to be the most delinquent in terms of paying for utility services.

**Table 12: Selected Financial Indicators for Large and Medium Sized PUCs (2009-12)**

Year (number of PUCs)	2009 (168)	2010 (168)	2011 (176)	2012 (176)
Current Assets (EUR 000)	475,144	487,850	532,258	551,283
Current Liabilities (EUR 000)	704,691	781,533	939,986	974,424
<b>Current Ratio</b>	<b>67.4%</b>	<b>62.4%</b>	<b>56.6%</b>	<b>56.6%</b>
Short-term financial liabilities (EUR 000)	51.932	61.720	98.538	88.429
Business Liabilities – Suppliers (EUR 000)	238.932	266.396	353.072	375.784
Long-term Credits (EUR 000)	32.471	41.317	35.881	44.618
Debt Ratio (Total Debt/Total Assets)			65.5%	68.4%
<b>Debt-Equity Ratio</b>	<b>144.2%</b>	<b>148.3%</b>	<b>153.4%</b>	<b>157.9%</b>

Source: Authors calculation based on available financial statements.

<sup>26</sup> This law went into force in March 2013.

<sup>27</sup> The Law on Enforcement and Security („Official Gazette 31/2011, 99/2011) prescribes separate enforcement procedures for utility services. The law has transferred enforcement related to PUCs exclusively to professional private enforcement officers.

<sup>28</sup> According to the Law on Consumer Protection, PUC can deny services of general economic interest if the consumer fails to pay for services within two months after payment is due.

### 3.3. Impact on Local Budgets

94. **Municipal PUCs receive significant financial support from LG budgets.** They receive not only direct current and capital subsidies but also additional amounts for the provision of specific contracted services. LGs also cover current and capital maintenance and in some cases purchase certain goods on behalf of PUCs. In fact, because most PUCs do not receive current subsidies directly from local budgets, looking at figures on reported budget subsidies may well be misleading.

95. **LGs also provide liquidity support to PUCs.** In some cases LGS also provide short-term financing to PUCs on subsidized terms when they have liquidity problems (e.g., to avoid the sanctions for late payments prescribed by the Law on Deadlines for Settlement of Cash Liabilities from Commercial Transactions). Such support is often simple bridge financing that is repaid during the budget year.

96. **LGs sometimes also decide to transfer liquidity from one PUC to another.** LGs sometimes ask that better-performing PUCs temporarily shift some resources to troubled enterprises. This was recently the case in Belgrade when a few PUCs had to temporarily prop up the Belgrade Transport Company.

97. **In 2012, 80 large and medium PUCs reported operating subsidies of close to 10.4 billion dinars (EUR 92 million).**<sup>29</sup> Almost 81.4 percent of total subsidies reported (8.5 billion dinars) went to large Belgrade- and Novi Sad-based PUCs. The largest recipients are transport companies: Belgrade (EUR 58 mln); Pančevo (EUR 2.7 mln); Novi Sad (EUR 2.6 mln) and Subotica (EUR 0.95 mln); and district heating companies: Belgrade (EUR 11 mln); Bor (EUR 1.7 mln) and Novi Sad (EUR 0.97 mln). All other recipients reported substantially smaller current subsidies.

98. **PUCs also receive capital subsidies to finance new assets.** These have a neutral effect on the income statement if the new asset is transferred to PUC. Once an asset financed from the local budget is transferred to a PUC, the utility treats it as an annual capital subsidy in an amount equal to the depreciation on it for that year. More than one-third of large and medium PUCs show capital subsidies in their annual financial statements, for a total of RSD 3.6 billion (EUR 32 million). Novi Sad is responsible for more than 33 percent of the capital subsidies LGs provide to PUCs, with Belgrade in second place at 11 percent. Financing is based on the program of maintenance adopted by the local authorities (Box 1).

99. **The next type of support is through service contracts.** For instance, services contracted to be provided by PUCs take 4–5.5 percent of the Belgrade budget (2009–12) and 2.5–4 percent of the Novi Sad budget.

100. **Financial support for PUCs accounts for about one-quarter of total budgets in the three largest cities (Table 13).** It is the biggest burden on the Belgrade budget, accounting for

---

<sup>29</sup> To approximate for operating subsidies for specific companies the study used items presented in statistical annexes of financial statements: Revenues from premiums, subsidies, grants, and other recourses. For example, in 2011, Belgrade Public Transport Company reported 4.93 billion dinars of these revenues, and the City of Belgrade budget showed a current subsidy of 4.8 billion dinars.

nearly a third of the total budget for the previous four years. Niš spends slightly less on its PUCs (27 percent of its annual budget), and Novi Sad spends least (17 percent).

**Table 13: Subsidies and other outflows to PUCs as a percent of the local budget**

YEAR	CURRENT MAINTENANCE (425)	SUBSIDIES (451)	CAPITAL MAINTENANCE (511)	CONTRACTED SERVICES	TOTAL OUTLAY FROM BUDGET FOR PUCS
<b>BELGRADE</b>					
2009	0,43%	7,01%	19,44%	4,81%	31,69%
2010	0,29%	7,94%	17,56%	4,00%	29,79%
2011	0,44%	7,51%	23,73%	4,84%	36,52%
2012	0,28%	8,58%	10,67%	5,44%	24,97%
<b>NOVI SAD</b>					
2009	0,06%	17,68%	2,03%	4,01%	23,78%
2010	0,10%	9,68%	0,96%	4,20%	14,94%
2011	0,08%	8,53%	2,32%	2,69%	13,62%
2012	0,08%	10,69%	2,90%	2,52%	16,18%
<b>NIŠ</b>					
2009	0,00%	6,81%	23,57%	0,00%	30,38%
2010	0,00%	4,53%	13,55%	6,14%	24,22%
2011	0,00%	3,36%	19,99%	6,13%	29,47%
2012	0,00%	0,08%	17,07%	6,71%	23,86%

Source: Author's calculation based on Reports on Budget Execution for Belgrade, Novi Sad and Nis, various years

### 3.4. Reasons behind PUCs Inefficiencies

101. **The huge inefficiencies in the LG public utilities sector are caused by numerous factors that are often interrelated.** The first group of problems relates to the fact that who owns the fixed assets that PUCs use is not clear. Closely related to this is corporate governance, as set out in the Law on PUCs. In addition, tariffs are often inadequate to cover operating costs, and since operating costs are high (among other reason because of overemployment and high salaries, as discussed in the previous chapter) there is little if anything left for investment. Finally there is limited involvement of the private sector in delivery of utility services. This chapter thus covers the four main reasons for suboptimal PUC performance: ownership, corporate governance, tariff and investments questions, and the role of the private sector.

#### Ownership and Property Related Issues

102. **The main impediments to PUC reform are unresolved ownership and property issues related to PUC fixed assets.** PUCs throughout Serbia have property conflicts with the local authorities,<sup>30</sup> the central government, and illegally connected users. These ownership-related problems have their roots in the communist era when social ownership was dominant, and the problem was exacerbated by changes in the law since the 1990s.

103. **Until 2006, even though LGs were founders and managers of PUCs, they did not formally own them.** In essence, until then all public property was de jure owned by the state.

<sup>30</sup> Including development directorates.

Thus, PUC assets belonged to the state; LGs and PUCs had only the right to use and manage them as public property.<sup>31</sup> In 2006 the new Constitution of the Republic of Serbia allowed property rights to be transferred to LGs. However, those provisions were not made operative until 2011, when the Law on Public Property (LPP) was passed.

104. **The ownership arrangement undermined stakeholder incentives:** (1) LGs had no incentive to invest in infrastructure and improve communal services. (2) Unresolved property issues turned off potential private investors. (3) Some crucial aspects of day-to-day PUC management, e.g., record keeping and calculation of depreciation of assets, could not be kept accurate.

105. **The LPP made possible the transfer of ownership of assets from the state to LGs.** Most important for PUCs is that the law enables transfer to PUCs of all or part of property used to provide public services.

106. **However, this solves only a fraction of the PUC problems because network assets are not covered.** The LPP enables transfer of ownership only for movables and real estate, not for network assets and specific state and municipal real property that may be held by a public entity. Because these assets cannot be included in their balance sheets, some PUCs cannot be creditworthy; cannot access capital markets, or make adequate provision for depreciation. They will continue to lack any incentive to maintain the assets adequately.

107. **It appears that PUCs have not been working actively to bring onto their books the assets they use.** Deadlines set by the LPP for submitting requests for transfer of property were recently extended, so it is not possible to estimate to what extent and when this process will be finalized. However, the extension itself suggests that PUCs did not promptly seize the opportunity to resolve ownership issues quickly.

108. **The ownership problem is exacerbated by the role of development directorates.** These are local public enterprises that manage infrastructure projects on behalf of LGs. They therefore can have a decisive role in the process of making decisions about investments in communal infrastructure (Box 2). Directorates often keep on their books for a long time significant fixed assets that are used and managed by PUCs without transferring ownership to them.

---

<sup>31</sup> Under the old Law on Assets Owned by the RS ("Official Gazette of Republic of Serbia", no. 53/95, 3/96, 54/96, 32/97, 101/05 – other law) public enterprises had the right only to manage the assets they use, which were owned by the Republic of Serbia (Article 7). More specifically, state capital in public enterprises consists of funds invested by the state, the right to use the assets, and rights owned by the state. PUC assets consist of movable and immovable assets, securities, and other property rights, including the right to use assets of general interest.

## **Box 2: Development Directorates and Communal Infrastructure**

In Serbia, the process of making decisions about communal infrastructure maintenance and investment is cumbersome; it reveals tremendous institutional inertia—the current process has to a large extent been intact for at least several decades. A special role is played by development (construction) directorates. These are in most cases established as public enterprises for design and construction of communal infrastructure investments and urban development: when local assemblies adopt programs to maintain communal infrastructure (as either an independent document or part of a general urban land development program), execution is delegated to directorates. The program covers maintenance and capital investments in such communal areas as sewage systems and roads financed from LG budgets. In some cases, when investment in infrastructure is financed by LGs through directorates, it appears on the balance sheets of both the PUCs and the directorate or local authorities. Thus, it is possible to have 60 percent of an infrastructure project recorded in a PUC's books and the other 40 percent in the books of a directorate or the local authorities. That means that the records related to the project that are presented in PUC balance sheets are often not reliable. While this has several practical implications, e.g., for how a PUC calculates depreciation, the worst impact is conflict and dispersal of responsibility coupled with slackness and significant waste of resources. Furthermore, when several decision makers have some responsibility for communal infrastructure, coordination is difficult. Often in municipalities it is not clear who sets priorities for investments in communal infrastructure (e.g., expansion of the road network), and PUCs and directorates tend to have their own priorities. Many problems result directly from the lack of accountability or arise because objectives are unclear and decision-making slow.

109. **Other ownership rights problems are caused by the huge amount of illegal constructions in Serbia.** There are about 800,000 illegally built structures in Serbia<sup>32</sup>—buildings for housing or businesses that were built without construction permits. Often these have been built in areas where urban development was never envisaged. Since LGs did not build networks for water, sewage, district heating, the investors who illegally built structures add the infrastructure they need to access the networks. Investors hook up to PUC networks formally by agreeing that they will hand over to PUCs the (illegal) network they have built. This automatically extends PUC infrastructure networks. While PUCs do charge for the services they provide to customers who are connected without proper licenses and approvals, the arrangements make it much more difficult to plan maintenance and capital investments. Often the networks built illegally are not fully compatible with those of the PUCs and are of much lower quality.

## **Corporate Governance and Organization of PUCs**

110. **Despite recent regulatory changes, management of PUCs is still highly politicized.** According to the LLSG and the LPE, the municipal assembly appoints PUC supervisory boards and the PUC chief executive officer is hired through competitive selection. Although the selection criteria prescribed by the LPE are relatively high, they are easily circumvented, so PUC directors and board members are often appointed as a political reward. This, combined with other ways to apply political influence, means PUC management is far from independent.

---

<sup>32</sup> For more details see World bank: Country Economic Memorandum, 2011

**111. Local authorities lack the capacity to monitor and analyze PUC performance.** PUC managers rarely evaluate and report on the cost-effectiveness of business activities or assess performance against specific indicators. In addition, senior and mid-level managers are predominantly concerned with the technical aspects of PUC operations. Request for improved monitoring of PUC finances could be introduced by an act governing the rights and obligations of the PUCs which is supposed to be adopted by LGs for all PUCs.

**112. Multiservice PUCs usually do not properly record costs and revenues for individual services.** Utility companies often provide several utility services, especially in smaller municipalities. Providing a heterogeneity of services raises definite methodological problems (e.g., how many employees are dedicated to each activity, what costs are associated with each activity, how to determine the price of utility services in a multiservice company, etc.).

**113. The relationship between municipalities and PUCs is not governed by service agreements.** Although local authorities must enact two legal documents related to PUCs (the communal activities decision and the “Decision on Establishment of the PUC”), PUCs otherwise operate without agreed criteria and guidelines for monitoring the quality of operations, progress toward better-quality services, or financial performance.

**114. PUC management could be improved by contracts with management** that specify targets for management, recognition for accomplishing targets, and penalties for failure. Both recognition and penalties should be primarily monetary.

**115. Restructuring PUCs through, e.g., spin-offs (divestiture) of noncore activities could improve efficiency.** PUCs should consider shedding two types of noncore activities: (1) activities that do not support the PUC’s core activity (e.g., tourism, catering, security, vehicle maintenance, etc.); (2) activities that do support the core activity (e.g., meter reading and maintenance, technical preparations and projects, some network maintenance) but that can be contracted out to the best bidder.

**116. PUC relations with spun-off activities need to be carefully designed.** Initially a noncompetitive contract with the spin-off could be arranged. The period of the contract would depend on the specific activity. If an activity needs more assets, the period should be longer to extend the payback arrangements. Initially the PUCs will own the spin-offs, but on a definite schedule they should be privatized by selling to the highest bidder. This concept should be applied with care for smaller entities; competition to provide noncore services in small communities could be minimal, and there could be some economies of scale in some operations. In some Central and Eastern European countries like Poland, the national government has set a deadline for PUCs to operationalize the spin-off strategy.

**117. PUCs are often very fragmented, which sometimes pushes up operational costs.** Merger of existing PUCs or creation of regional PUCs could bring cost savings. The first candidate for this type of PUC would be regional landfills with solid waste recycling facilities. Over the medium term the best way to do this would be to involve the private sector.

**118. There are good examples of regional PUCs from other transition economies.** One model in recent years that could be replicated in Serbia is the six regional solid refuse centers, including recycling facilities and incinerators, in Poland, Romania, Slovakia, and the Czech

Republic; these have a substantial recovery rate. Solid waste recycling can generate considerable cash inflow for PUC. Another candidate for a regional PUC is water systems that could supply several cities. Again, that can be done by involving the private sector because water distribution can be accurately measured and billed to customers by branches in each city.

## **Tariffs and Economic Regulation**

**119. Tariffs in sectors that rely on user charges to cover their operating costs are often not high enough to pay for maintenance and investment in communal infrastructure.** Inadequate level of tariffs in many cases doesn't allow PUCs to provide services at the desired level, while at the same time they are giving users wrong incentives, leading to inefficient use of resources.

**120. Since 2013 only local authorities may set PUC tariffs.**<sup>33</sup> PUCs that propose a price change must justify the request to the local assembly to secure its approval. The central government has neither direct nor indirect control over prices; it merely supervises whether PUCs comply with the regulations on employment and wages in the public sector.<sup>34</sup> Similarly, other regulators are not involved apart from the limited role of the Energy Agency, which regulates natural gas prices.

**121. Transition economies have had a variety of experiences with control over tariffs.** For example, in 2004 the Slovenian government introduced rules on how local public utilities were to set prices. The idea was to introduce a benchmarking regulatory model resembling the UK regime for water and sewerage industry prices. However, soon after the rules were introduced it became clear that the objective was too ambitious; no national regulatory agency was established<sup>35</sup>, and the rules never came fully into effect<sup>36</sup>.

**122. The LCA has introduced a cost-plus pricing formula.** The price of utility services covers operating costs, investment costs (based on the PUC business plan), and a profit. Unfortunately, one major weakness is that the current cost-plus formula does not address the key problems of incentives and production inefficiencies.<sup>37</sup> Another is that capital investments are not equated to the annual cost of depreciation; instead the law uses investment costs based on the

---

<sup>33</sup> This applies to water supply, treatment and disposal of rainwater and wastewater, district heating, solid waste management, public transportation, management of public car parks, and public lighting.

<sup>34</sup> To prevent a scenario in which higher tariffs could be used to increase either PUC wages or the number of employees, in 2006 the government introduced a second layer of price control by adopting measures to limit tariffs to the level of inflation, under threat of temporarily deferring the transfer of funds from the budget. However, in 2012 the LPE abolished this regulation to allow for modification of tariffs as a consequence of increased costs other than labor.

<sup>35</sup> Serbia already has some independent regulatory agencies, such as the Energy Agency.

<sup>36</sup> Filippini, M., N. Hrovatin, J. Zorić, "Productivity growth and price regulation of Slovenian water distribution utilities", *Zbornik radova Ekonomskog fakulteta u Rijeci*, 2010, Vol. 28 (1) : 89-112

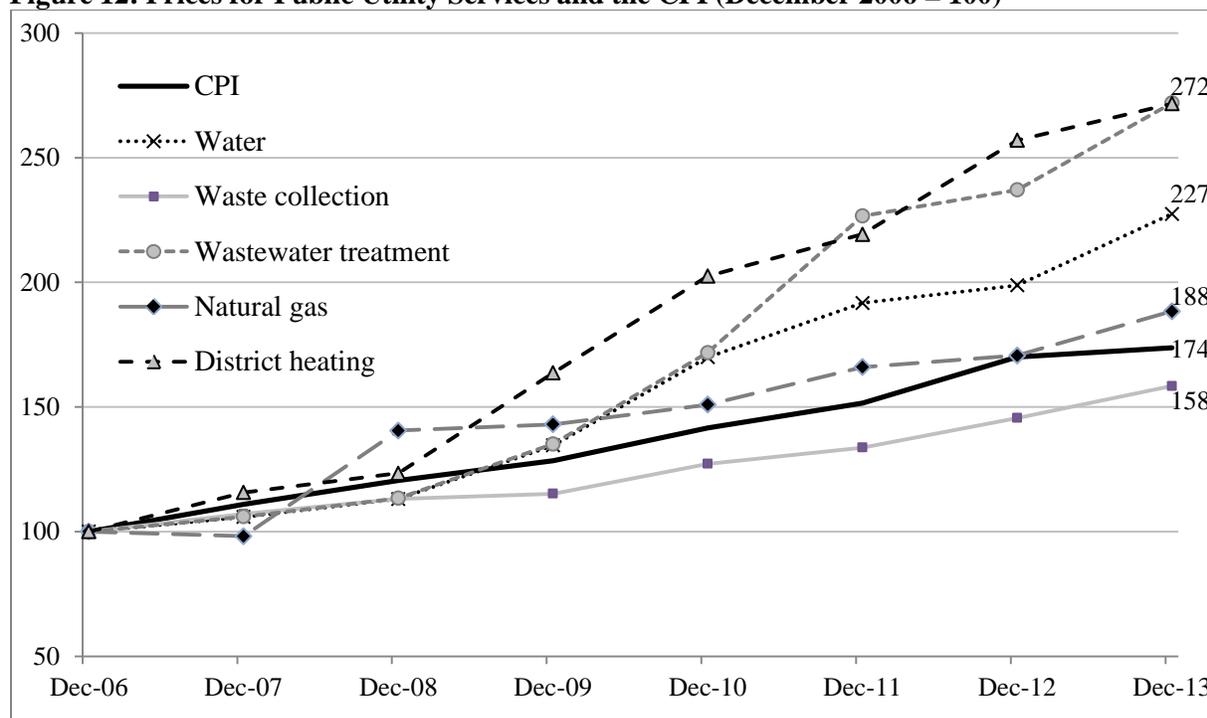
<sup>37</sup> On the other side a number of countries adopted incentive-based regulatory schemes for water distribution and other utilities, e.g., a price cap model (RPI-X model, retail price index less efficiency gains), a revenue cap, or a yardstick regulation model; these are based on benchmarking—measuring company production efficiency against a reference performance.

PUC business plan, a relatively unreliable parameter. The ownership issue already discussed further complicates use of this formula.<sup>38</sup>

123. **Natural monopolies have the option of using nonlinear tariffs to solve the problem of inefficient linear average-cost pricing.** Given substantial capacity constraints, as is the case for most PUCs in Serbia, increasing the block tariff should be both viable and simple to implement. A block tariff with an ample first block could substitute for a “life-line” tariff, and for subsidies to poor households.

124. **Despite several layers of price controls and the initial reluctance of local authorities to raise prices, the prices of most public utility services have gone up considerably over the past seven years** (Figure 13). The highest increases were for district heating and wastewater treatment—more than 1.5 times the inflation rate. However, price increases for solid waste collection lagged behind the consumer price index (CPI): prices in real terms are about 10 percent lower than in 2007.

**Figure 12: Prices for Public Utility Services and the CPI (December 2006 = 100)**



Source: MoF

125. **While price increases enabled PUCs to decrease total aggregated losses, without resolving production inefficiencies, any further price increase will have limited if any positive effect in the long run.** Within the current regulatory and institutional framework, tariff increases may be used to cover rising costs due to production inefficiencies, poor management,

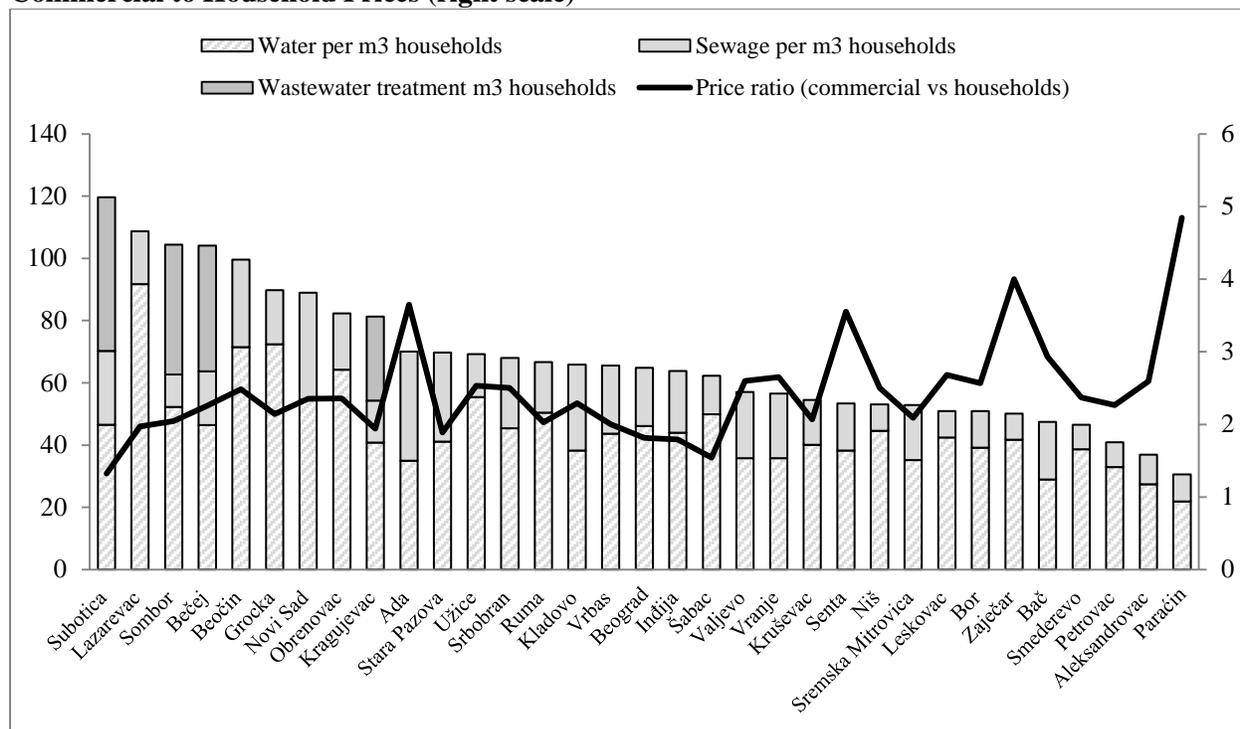
<sup>38</sup> Besides covering operating costs, the LCA sets out four other principles to guide utility services price formation: consumer pays, polluter pays, affordability, and nondiscrimination (except where different tariffs are set because costs are different). Generally, the tariff regulation section of the LCA is vague; it is not clear how these principles will be applied in practice.

or inadequate or nonexistent planning. Since most PUCs already suffer from significant billing and collection problems, more price increases could aggravate the problem.

126. **Differentials in pricing between different classes of users are widespread.** While the principle of nondiscrimination should remove price differences between households and businesses it is not clear how long this adjustment will take, or how it will be achieved. Because prices for households are kept down artificially, local authorities heavily rely on shifting the burden to business users by cross-subsidization between different groups of users.

127. **As a rule, tariffs for commercial customers are significantly, sometimes up to five times, higher than tariffs for households (Figure 14).** However, some discrimination should continue to be justified by differences in the quality or quantity of services delivered (e.g., the use of block tariff pricing, with one price for a minimum amount of consumption and another for consumption above that threshold).

**Figure 13: Water, Sewage, and Wastewater Treatment Prices, 2014 (left scale) and Ratio of Commercial to Household Prices (right scale)**



Source: MoF

### Access to Financing and Private Sector Participation

128. **A major problem PUCs confront is lack of funding for both new investments and maintenance of existing infrastructure.** Municipal budgets<sup>39</sup> generally dedicate too little money for these purposes to cover all the requirements of PUCs.

<sup>39</sup> Besides municipal budgets, capital investment are primarily financed by the national government, international financial institutions, and development assistance programs.

129. **As more and more local authorities reach the legal debt ceiling, capital investments must increasingly be financed by the PUCs themselves.** If investments are funded only from tariff-based revenues, the tariff rate must be set high enough to cover both operational and investment costs. Pricing must then be based on average long-run incremental costs. The consequence is that new capacity for PUCs can be funded only by all current users. The introduction of an impact fee to be paid by new customers enables PUCs to cover the costs of adding capacity to local public utilities rather than levying on current customers.

130. **Public-private partnerships (PPP) may offer some solutions.** PPPs could be attractive in particular to LGs that have hit the debt ceiling but need significant capital investments<sup>40</sup>. However, institutional and regulatory restrictions, lack of experience with operating in PPPs, and insufficient quality of proposed projects deter investors. In any case, LGs need to assess possible contingent liabilities stemming from PPP arrangements, and all potential LG obligations and liabilities should be clearly specified. Since the Law on PPP and Concessions came into force in 2011, the PPP Commission has given only eight PPP projects a positive opinion; half were urban transport service agreements.

131. **Although Serbia has much to learn from the mixed experience of other transition economies, private participation in delivery of utility services could bring benefits.** The most promising area for private sector involvement is SWM with substantial recycling activities to generate sustainable cash flow. Big water companies (as it was the case in cities like Bucharest, Sofia, and Budapest) can feasibly be privatized by involving a strategic partner, but such involvement of the private sector can be controversial unless it is carefully regulated. Investors usually do not find small water companies to be attractive<sup>41</sup>.

132. **The private sector could be brought in by introducing competition for the market.** Some local public utilities are natural monopolies due to economy of density rather than scale, and their sunk costs are fairly negligible (garbage collection, public hygiene, maintenance of public spaces, etc.). In those cases competition for the market could be introduced by contracting out the services.

133. **Contracting of these services should be done through competitive bidding.** The main bidding criterion should be the amount of compensation from the local budget that is required to deliver a utility service. All other provisions regarding the activity itself should be determined by the local authorities before the bidding process begins.<sup>42</sup>

134. **Contracts with PUCs should retain a public service obligation and oblige the operators to provide the service to all customers within the specified area.** Because the costs of providing service to different customers within an area vary, cross-subsidization can be expected. Local authorities should take this into account when making decisions about the area to be serviced.

---

<sup>40</sup> Nenezić, D, B. Radulović „Analysis of Finance Options, Models, and Financial Support Measures for Public-Private Partnerships in Serbia“, FREN Quarterly Monitor No. 30 (July–September 2012), 62-72.

<sup>41</sup> Big water companies privatization case studies and national context reports are available at <http://www.watertime.net/> (a research project funded by the European Commission).

<sup>42</sup> How long the contract should be for depends on the activity. The term can vary from one to five years. The shorter period should be envisaged when contracting out begins so that the authorities can gather operational experience.

### 3.5. Conclusions and Recommendations

135. **LGs own numerous enterprises; among them the most important in terms of financial resources, employment, and impact on budgets are utilities.** In Serbia PUCs generally operate inefficiently, with combined annual net losses of about EUR 46 million in 2012. Consequently, PCs need substantial financial support that averages about one-quarter of local budgets.

136. **Inefficiencies are caused by numerous factors that are often interrelated.** The first group of problems is related to the fact that ownership of the fixed assets that PUCs use is not clear. Closely related is corporate governance as set by the Law on PUCs. And the inadequacy of tariffs levels often leaves only limited funds for investment. The following recommendations for dealing with the inefficiencies are grouped by the time needed for their implantation.

137. **To achieve more efficient provision of the municipal infrastructure services and reduce the pressure on local budgets, several important reforms are necessary.** These address problems related to ownership, management, operational restructuring, tariffs, and regulation.

#### *Short to Medium-term Measures*

138. **PUCs need to complete assets inventory and make their balance sheets more accurate.** All assets that PUCs use to provide services should be transferred to the PUCs. The LPP should be amended to enable PUCs to become owners of the networks they operate, i.e., assets that are crucial for their operations, and to allow for resolution of illegal networks built by investors without construction permits.

139. **Monitoring of both the performance and the financial reporting of PUCs needs improvement.** PUCs operate without set criteria and guidelines for monitoring the quality of any of their operations. PUC managers rarely evaluate and report on the cost-effectiveness of activities and do not monitor specific performance indicators. The focus of PUC management needs to be shifted from the technical to the financial aspects of their operations.

140. **LGs can use formal service agreements to professionalize management of PUCs.** Managers should be focused on raising production efficiency and reducing pressures on local budgets. PUC management could be professionalized through formal management agreements that give managers solid and clear benchmarks and incentives.

141. **Corporatization is another option to make PUCs more efficient.** LGs might consider organizing their utility companies on principles similar to companies governed by the commercial law. Incorporating PUCs could transform them into either limited liability or joint stock companies, with the local authorities as the initial owner of all shares. It should be considered as the first step, i.e. a necessary condition for improving efficiency together with the contract agreements, that should be followed by other measures including private sector participation.

142. **Investments in utilities should be transparent.** Investments in physical networks should be done by the PUCs themselves, not by development directorates on their behalf, as is the case now. LGs could consider the use of PPPs for new investments, in particular for regional projects, although such arrangements need to be carefully thought through. Non-tariff instruments for funding investments, like impact fee, or environmental surcharge could be considered as well.

### *Medium to Long-term Reforms*

143. **PUCs could become more efficient by restructuring, including spin-offs of noncore activities, in terms of both assets and labor.** Relations with spun-off activities need to be carefully designed. Contractual arrangement with the spin-off could initially be noncompetitive. This approach might also offer an opportunity for raising privatization revenues through sale of noncore businesses.

144. **Organizing PUCs regionally can be justified economically.** The first candidate for this type of PUC is regional landfills with solid waste recycling facilities. Over the medium term the best way to do this would be to involve the private sector.

145. **Private sector participation in the delivery of utility services could be further promoted.** Competition for the market could be introduced by contracting out services delivered by PUCs that are natural monopolies due to economy of density rather than scale, and which have negligible sunk costs (garbage collection, maintenance of public spaces, park maintenance, etc.).

146. **Tariffs should be capped and supervised by an independent regulator, sector by sector.** Capping prices will enable costs to be reduced because cost reductions are channeled to the profit of PUCs. Contract regulation could be considered as an alternative to establishing new regulatory authorities in the industry where they do not exist. Natural monopolies could be allowed to use block tariffs in order to solve the problem of inefficient linear average costs pricing.

## 4. Efficiency Gains through Better Financial Management

*Serbia made significant progress in improving public financial management (PFM) between 2001 and 2008, but reforms have since slowed. PFM-related problems have become most obvious at the sub-national levels of government where capacities are weakest. The problems start with budget planning and carry all the way over into external oversight and scrutiny. The legal framework governing PFM is incomplete and in some segments is missing altogether. Financial management information systems (FMIS) are fragmented, incomplete, and often not harmonized with those of the central government. These systemic weaknesses are the result of both insufficient support from the national level and a lack of diligence from local administrations. The agenda for PFM-related reforms is thus comprehensive. If reforms are implemented, local budgets would be far more transparent, accountability would be clear, and significant savings could be achieved. Efficiency gains could be expected from lower costs for goods and services, better control over the wage bill, and more transparent PUC operations.*

### 4.1. Introduction

147. **Serbia made major improvements in PFM between 2001 and 2008.** The first generation of reforms was largely completed with the introduction of the Treasury single account; the improvement of internal and external scrutiny and audit through the Public Internal Financial Control (PIFC) framework and the work of the SAI; the reform of tax administration, and the establishment of the Public Procurement Office and the Public Debt Administration.

148. **Between 2008 and 2012 progress with reforms slowed, and there were even some reversals.** The budget calendar was not always followed, external scrutiny deteriorated, arrears accumulated, distortions appeared in the pay and grading system, and numerous extra-budgetary funds were created.

149. **In the past two years, efforts to reinforce the PFM system have been renewed.** The number of earmarked revenues has been reduced, many extra-budgetary funds have been closed, commitment controls are now more effective, a central registry of public employees has been introduced, and the central payroll system has been improved. The public procurement law adopted in December 2012 aimed at greater alignment with the EU *acquis communautaire*, and the 2011 Law on Public Property has addressed the public property issue.<sup>43</sup>

150. **The system for macro-prudential oversight of public finances has also been improved.** First, the macro-fiscal responsibility framework was built up by the introduction of quantitative fiscal rules for the deficit, wages, and pension indexation and for managing the stock of debt. A related measure was creation of an independent Fiscal Council and the adoption of an annual Fiscal Strategy Paper, which helps to improve accountability and the transparency of government generally.

151. **However, implementation lags behind law-making.** At all levels of government there are major problems and delays with putting the new PFM system into operation. This is most

---

<sup>43</sup> The impact of this law is discussed in detail in Chapter 3.

pronounced at the local level.<sup>44</sup> Thus recent SAI audit reports for 24 LG refrained from giving any opinion on the quality of budget accounting and assets management for 20 LGs, and for the other four they gave an opinion “with reservations” because of inadequate PFM systems.<sup>45</sup>

**152. Unfortunately, too, some legislative changes, such as revisions of the Law on Public Debt, have had huge negative effects.** The debt law now allows de facto for unlimited long-term borrowing by LGs. It also allows LGs to issue municipal bonds, which can significantly increase their debt without a clear link to improved infrastructure or any other spending priority.<sup>46</sup>

**153. The three main reasons for the poor PFM performance of LGs are insufficient capacity, lack of internal procedure rulebooks, and nonstandard information technology (IT) systems.** The capacity shortage is the main reason for poor PFM outcomes and there is only limited investment in building staff skills (in most cases this is done by the state level institutions – Treasury or SAI<sup>47</sup>). Most LGs lack internal rules and procedures<sup>48</sup> for operationalizing the new laws, and they have inappropriate IT systems that often are not synchronized with those of the central government.

**154. To meet their fiscal savings targets, LGs need to improve PFM.** The remainder of this chapter discusses findings related to three broad dimensions of PFM: budget planning and revenue management, budget execution and control, and external audit and scrutiny. The chapter closes with recommendations.

## **4.2. Budget Planning and Revenue Management**

**155. Budget planning and revenue management are closely connected.** Planning requires estimates of revenue and expenditure for the budget period so that local legislatures can decide on policies and practices for the collection and allocation of resources. Revenue management relates to how LG resources are determined, collected, and managed.

**156. Budget planning for LGs is closely connected to, and dependent on, that of the central government budget process.** LGs are incorporated into the annual national budget process through the Budget Systems Law (BSL) and related regulations and instructions. Plans are prepared for the next budget year with broad projections for two subsequent years. The BSL

---

<sup>44</sup> The issues discussed in this chapter were identified in SAI reports and drawn from the findings of field visits. The report may present a rosier picture than is experienced by LGs that were not covered by the study: smaller and more remote municipalities face additional challenges in terms of access to professional staff, engagement with central government, and economies of scale in revenue collection and expenditures. The LGs visited and the SAI reports represent about 45 percent of the Serbian population.

<sup>45</sup> In the 24 municipalities that were audited in 2013, SAI brought criminal cases (total 47) against individuals responsible. It also issued another 153 charges for violations of the law, mainly for assumption of financial obligations beyond those envisaged by the budget.

<sup>46</sup> This issue was explained in greater detail in the first phase of this report published in 2013.

<sup>47</sup> The SAI has so far organized three workshops for LGs to discuss the main issues identified in its audits. Workshops will continue in 2014 with the help of the Standing Conference of Towns and Municipalities.

<sup>48</sup> Such as rulebooks on budgetary accounting, budgetary accounting and reporting of indirect budget users, and internal audit.

requires that LGs budgets be prepared in accordance with the Fiscal Strategy (Article 31, 9) and MoF instructions (Article 31, 11).

**157. The annual budget calendar for LGs and adherence to it depend largely on the central government.** The BSL sets deadlines for procedures that LGs must adhere to in preparing and approving budgets (Article 31, part 2). The MoF coordinates the budget process and issues instructions to central and LG authorities at various points throughout the year. The law also defines the macroeconomic assumptions local authorities are to use in preparing budgets (Article 36). For that reason the timely completion of the fiscal strategy and issuance of instructions are crucial to enable LGs to prepare their budgets as scheduled.

**158. The instructions provide a consistent foundation for LG budget preparation.** The instructions the MoF issues to local authorities cover such areas as wage principles and number of staff, subsidies policy, and ceilings on new borrowing. These requirements also provide a base for consolidated reporting on almost all important aspects of LG finances.

**159. Budget instructions often come later than the law prescribes.** The central government has often adopted the fiscal strategy and instructions or decided on the amounts of individual transfers very late in the budget year, which has seriously compromised the LG budget process.

### **Box 3: IMF Fiscal Affairs Department (FAD) PFM Assessment 2013**

The IMF FAD report on “Strengthening Budget Planning and Budget Execution” from December 2013, identified a need for better fiscal coordination between central and local governments. It also recognized that introducing program budgeting for both central and local entities by 2015, as prescribed by the BSL is highly challenging. The problem is particularly obvious for LGs, which have already been having trouble with the existing economic classifications. The FAD recommended that program budgeting be introduced at the local level only after it was fully incorporated into the budget of the Republic in order to allow gradual development and a period of testing.

The same report also points to the fact that in 2011 and 2012 the budget calendar as prescribed by BSL had not been followed by the central government, which had delayed LG budget planning because in both years they were informed about their revenues in December rather than in the summer, as the budget calendar specified.

**160. The current system of budget planning and revenue management suffers from numerous problems.** From the point of view of LGs, the most important issues<sup>49</sup> are (1) frequent changes of the legal framework—often implemented in the middle of a fiscal year; (2) excessive central government interference in local budget planning; (3) delayed issuance of budget instructions; (4) changes in the amounts of transfers and shared revenues during the fiscal

---

<sup>49</sup> SAI reports that in most LGs the budget formulation process is not in line with the BSL. In Novi Sad, for example, the audit report for 2010 observed that “a budget was adopted which was not balanced, contrary to Article 5, Paragraph 8 of the BSL stipulating that budget revenues and receipts must be in balance with budget expenditures and outlays.” In Čačak, the audit report found that there was no compliance with the Articles 40 and 41 of the BSL during preparation of the Decision on the Budget, and “revenues and expenditures of budget beneficiaries were not planned and expenditures and expenses were not planned according to all sources of finance, which is not in line with provisions of Article 29 of the BSL.”

year; and (5) poor revenue management. Even though resolution of most of these issues depends on the central government, the role of the LGs should not be downplayed.

161. **First, frequent changes in the laws governing the PFM system that determine the responsibilities of LGs make it very difficult for them to budget realistically.** Changes that have significant fiscal impact on local budgets are often adopted without reasonable public consultation, and they often became effective immediately upon their approval by the state parliament, i.e., in the middle of the fiscal year. The most drastic example was the March 2009 cut in transfers to LGs.

162. **In addition, the laws, decrees, and by-laws that regulate the budget system and decentralization in general have not been reviewed for consistency,** and there has been no attempt to integrate them into a comprehensive set of PFM regulations. The SAI noted that lack of harmonization of the laws and regulations that affect PFM leads to ambiguity, leaving some areas open to interpretation.

163. **Second, the central government leaves LGs only limited room for discretion in managing their budgets.** Though the existing legislation gives LGs explicit responsibility for formulating realistic budgets and deciding on spending priorities without the involvement of the central government, LGs argue that key building blocks for their budgets are highly dependent on decisions outside their control. For instance, the central government introduced the law specifying the maximum number of employees in local administrations in 2009 and regularly determines wage increases (see Chapter 2). Complaints about interference in revenue collection are even more significant.

164. **Third, the central government often does not prepare budget instructions in line with its own budget calendar, causing delays for LGs.** The instructions were delayed several times, most recently in 2012. This reduced the time LGs had to prepare their budgets and submit them to local parliaments. In some cases this led to temporary financing for the first quarter of the fiscal year.

165. **Fourth, several times between 2009 and 2013 there were in-year changes in local transfers.** While it may be argued that these were extraordinary measures necessitated by the global economic crisis, they still caused serious disruptions for LGs. The lack of medium-term predictability of transfers makes it difficult for LGs to honor their annual commitments and medium-term plans, in particular those related to investment projects that span several fiscal years.

166. **Fifth, LGs need to improve their collection of local taxes and fees.** The SAI identified three main problems related to collection of their own revenues: (a) not all local taxes and fees that the law allows are actually imposed; (b) uncollected receivables are high; and (c) some revenues are not recorded. Obviously, substantial additional revenues could be raised by ensuring that all taxes and fees allowed are collected,<sup>50</sup> but there are many reasons why revenue raising and collection are ineffective, some politically motivated, others economically driven.

---

<sup>50</sup> Kragujevac did not collect, for example, municipal fees for having gaming machines, temporary use of public areas, and use of showcases to exhibit goods outside business premises etc. In Novi Sad and Belgrade, the audits found insufficient collection of fees on construction sites.

Some are in fact more technical, such as the absence of accurate ownership and usage records for land, assets, and utilities (see Chapter 3).

### 4.3. Budget Execution and Control

167. **Budget execution relates to the management of resources after legislatures authorize budgets.** It covers such processes as commitment controls; flow of funds (including transfer to controlled or related entities); controls on the sources and use of funds (including internal audit); and accounting for and reporting executed transactions. This section also discusses some specific issues, such as management of the wage bill and public procurement and public property, adding perspective to issues covered earlier in this report.

168. **Several unresolved issues are barriers to better budget execution.** The most important are lack of clarity about what is legally required, such as accounting standards; lack of a unified financial management and reporting system; absence or insufficient capacity of the internal audit function; inadequate systems of financial management and control, especially of commitments; irregularities in how wages and benefits for public employees are determined; public procurement irregularities; and difficulties in managing public property. These issues are discussed in the following subsections.

169. **In general the same laws define budget execution for all levels of government.** The most important is the BSL that sets out the budgeting process and calendar; defines the functions of the local as well as the national Treasury; and sets requirements for internal audit within budget users and external audit by the SAI and commercial auditors. Other laws that relate to public property, public procurement, etc., cover both local and central governments.

170. **Some LGs argue that some central government laws and regulations are difficult for them to follow because they do not take adequate account of LG circumstances.** As a result, some LGs add their own rules to central government requirements. Although these should not conflict with or override national provisions, that sometimes happens. This is most obvious in the area of LG employee pay and grading.

171. **Specific regulations apply to accounting and financial reporting.** The main ones are the Regulation on Budgetary Accounting, Regulation on Application of International Public Sector Accounting Standards (IPSAS) and the Guidelines on Standard Classification and Chart of Accounts. Many of these requirements are not harmonized. For instance, current law stipulates that budgetary accounting be on a cash basis, but the Guidelines on Standard Classification and Chart of Accounts state that they were prepared in line with the 2001 *Government Finance Statistics Manual*,<sup>51</sup> which follows accrual principles.

---

<sup>51</sup> A pre-publication draft of GFSM 2014 has been prepared; it is aligned with the changes in macroeconomic guidelines and internationally recognized manuals such as the IMF *System of National Accounts, Balance of Payments and International Investment Position Manual* (6th edition) and *Public Sector Debt Statistics: Guide for Compilers and Users*, published by the Inter-Agency Task Force on Finance Statistics (IFFS).

## Accounting and Financial Reporting

172. **Budget users keep accounts and prepare financial reports.** Indirect budget users prepare annual financial statements for the previous year and submit them to the responsible direct budget user by February 28 of the current year. Direct budget users submit their annual financial statements to the responsible LG entity; entities that have indirect budget users reconcile the information from them and prepare consolidated financial statements. The LG entity responsible for finance consolidates financial statements by May 15 and submits them to the LG executive body.

173. **LG treasuries establish treasury single accounts (TSA), with subaccounts for all their budget users.** These local TSAs and the TSA of the Republic make together system of consolidated Treasury Single Account. Operations of local treasuries are formalized in the guidance on the work of a treasury that each LG is supposed to adopt; in practice the guidance is either missing or incomplete. Each annual LG financial report is reconciled in the Treasury administration based on the transactions of the LG TSA.

174. **Among the numerous problems related to the chart of accounts, the most important is that it is severely outdated and inadequate for operations of LGs.** A single, government-wide chart of accounts based on GFSM 2001 was introduced in 2002. It is uniform for all budgetary users, although the MoF can modify it at the request of budget users. One major problem is that the chart of accounts, which is aligned with the GFSM, uses accrual accounting logic, while Serbia's general government sector—all levels of government—still use cash-based accounting. There is also no clear and detailed guidance on what types of transactions are to be allocated to which account.

175. **In addition, some LGs are concerned that the chart of accounts does not take into full account the particularities of certain local transactions.** All the cities whose audit reports the SAI analyzed had difficulty in accurately classifying and accounting for revenues and expenditures in line with the Guideline on Standard Classification and Chart of Accounts.<sup>52</sup> Without the flexibility to create new budget codes or categories on their own, LGs sometimes are not sure how to record receipts or expenses that do not seem to fit within the chart of accounts. Some seek guidance from the MoF or submit requests for consideration of new entries, but this usually takes so much time it can make it difficult to meet reporting deadlines.

176. **The SAI audits identified other common weaknesses in LG accounting.** Arguably the main issue is that asset records are not complete; LGs do not account for some high-value assets (buildings, sports stadiums, roads, etc.). The root of this issue is the fact that LGs did not legally own any property until the 2011 Law on Public Property gave them full rights to do so. Since the law is relatively recent, having complete and accurate records of assets is still a work in progress (see Chapter 3). Another accounting issue is the large amounts of receivables. It should be noted that to a large degree the outstanding balances for both receivables and liabilities have not been reconciled, in that a third party either has not confirmed the balance on an LG's books or has come up with a different figure. One issue raised by certain LGs had to do with difficulties in consolidating the financial reports of indirect budget users. Some LGs state that while they can

---

<sup>52</sup> For example, one question was how to classify external loan funds provided for a project in a municipality when the national government guarantees the loan. Another was where to attribute the proceeds from privatization.

perform consolidations at general levels of budget classification, they cannot do so at the analytical levels the MoF requires because not all their expenditures fall in chart of accounts categories.

### **Financial Management Information Systems (FMIS)**

177. **LGs have no unified financial management and reporting system.** Each administration chooses the software it wants to use for accounting and reporting. According to the SAI, most of the software in use for administering finances is outdated, and what is in use are mostly commercial systems, designed for businesses and modified to accommodate PFM requirements.

178. **The lack of FMIS uniformity causes a number of problems.** Some LGs claim that the systems available are not tailored to LG operations; some use multiple software solutions (e.g., separate software for financial accounting and for revenues); most do not have software that accommodates information on the maturity structure of arrears and receivables, etc. As a result, LG staff often must compile information manually—a heavy charge on staff time and efficiency.

### **Commitments Control**

179. **The most common irregularities in municipal management of expenditures stem from LGs taking on commitments that are not covered by appropriations.** In fact, most of the legal proceedings the SAI initiated in relation to audits of 2012 accounts (47 cases from 24 audits) are based on creation or payment of liabilities in excess of appropriations.<sup>53</sup> SAI audits often identify failure to record commitments accurately with the right budget classification codes.

180. **The MoF has introduced a new reporting system to better monitor commitments and arrears.** The Treasury now monitors payments and commitments to ensure that local authorities do not incur arrears and pay their obligations on time. RINO software allows it to monitor commitments and payments in real time for central and local governments and associated entities. The Treasury believes this application facilitates transaction processing in a way that makes it convenient for LGs to honor payment due dates, rendering accumulation of arrears no longer an issue that can be explained purely on technical grounds.

181. **The BSL allows the MoF to suspend transfers to local authorities that do not comply with requirements for financial management.** The LGs consider this to be unduly punitive, since transfers have been suspended even when technical limitations of the system prevented them from recording transactions. The LGs argue that the disruptive effects of suspending transfers make it even more difficult to manage within their allocations. At the very least, there seem to be grounds for closer cooperation between central and local authorities to determine the most effective ways to improve the timeliness of payments and avoid arrears.

182. **However, the IMF FAD 2013 report (Box 3) points out that data on arrears are still not comprehensive:** in particular indirect budget users and public enterprises do not provide complete data on arrears. So far, data indicate that local arrears are not yet a sizable problem but

---

<sup>53</sup> In Belgrade, for instance, commitments were about RSD 16 billion higher than the available appropriations.

should be monitored. Finally, it also recommended broadening the coverage of local fiscal reporting to capture all pertinent entities.

### **Internal Audit and Control Framework**

183. **Most LGs in Serbia have not established the internal audit functions required by law.** In the SAI audits of 2012 accounts, of 24 LGs audited, only 3 had internal audit units and even in those the function lacked the necessary capacity or was not fully operational. Internal audit is a relatively new concept adopted in Serbia as part of the EU-supported PIFC concept for managing public finances.

184. **In addition to internal audit units, the BSL requires budget inspection for each LG.** Ever since it was introduced, the internal audit function has been confused with that of budget inspections. Budget inspections have a long history in Serbia; progress with establishing internal audit units is much more recent. Some LGs have tried to meet the requirements by simply adding the internal audit function to the budget inspection unit. This is not a good practice. The primary role of budget inspection is to verify compliance with the law; internal audit is directed to reviewing internal procedures and operations in order to provide recommendations for improvement.

185. **Central government does not give LGs sufficient support in this area.** The MoF Central Harmonization Unit has focused attention on establishing and strengthening internal audit and control arrangements at the republic level without much guidance and support for LGs. There have been conferences to raise the awareness of LG management about the role, importance, and responsibilities of the internal audit function, but the support usually stops there.

186. **This is an area where lack of written procedures and rules is an obvious source of concern.** LGs do not have in place the procedures, checks, and balances necessary to ensure that public funds are used properly. Most LGs have executed expenditures without valid documentation and approvals. The challenges that staff face in understanding, instituting, and following the regulations mandated by law contribute significantly to the difficulties of applying internal controls, internal audit, and procurement procedures in LGs. The MoF and most LGs admit that budget planning and execution departments are usually understaffed, underpaid, or both.

### **Management of the Wage Bill**

187. **Managing the wage bill is a significant challenge for the central government and LGs alike** (see Chapter 2 and Box 4). A particularly disconcerting phenomenon observed uniformly in all LG audit reports is irregularities in how wages and benefits for public employees are determined. Either there is direct disregard of the legal ceilings for salaries and eligible benefits, inaccurate application of the coefficients set for calculation of salaries, or both. As a result, salaries and benefits, such as one-time bonuses, health benefits, education and housing allowances, and inappropriate amounts of severance pay, have been paid from municipal budgets without any legal basis.

#### **Box 4: Wage Bill Management Irregularities**

While in technical terms irregularities are common in LGs, larger cities seem to enjoy somewhat more flexibility in dealing with their consequences. Information collected during this study suggests that it is not uncommon for LGs to take on expenditures beyond their jurisdictions—especially when the expenditures serve sociopolitical objectives. Belgrade, for example, decided to pay higher wages to preschool teachers than the law allowed. Reminded that this was illegal, the LG undertook a public campaign to justify its action. Similarly, in applying wage and salary coefficients, Belgrade made a case to the central government to modify the coefficients in a way that benefited the city more than other LGs.

### **Public Procurement**

188. **Serbian LGs apply public procurement procedures inconsistently.** In all cities whose audit reports were reviewed, systematic failure to apply public procurement procedures in contract competition, award, negotiation, execution, and completion is apparent. As the audit reports noted, if public procurement procedures are not applied fully and systematically, it becomes impossible to determine whether the LG received what it paid for, or whether works and services were appropriately valued and priced in the first place.

189. **The SAI reports confirm a variety of irregularities.** LGs award many contracts without conducting the open competition required by law, and enter into contracts in which the contract value has not been negotiated. Often there was no signed contract that specified the scope of work to be undertaken and its price, and work commenced based only on pro forma invoices from service providers. Many contracts also do not conclude with completion certificates signed by designated authorities, making it difficult to ascertain whether the government received the full extent of the services it paid for.

190. **The SAI has identified public procurement as potentially the biggest source of corrupt practices.** The general failure to plan budgets adequately affects the ability of LGs to plan procurement adequately, which makes the procurement process highly vulnerable to interference and manipulation. The SAI noted that in 80 percent of cases brought before the central public procurement regulator, it ruled against the LG, most often for unfair preference for a local contractor.

191. **Lack of capacity is another reason for deficiencies in the procurement process.** According to the Public Procurement Authority (PPA), the capacity gap prevents full compliance with the Public Procurement Law. Staff of LGs and municipal enterprises need training in application of the rules for public procurement<sup>54</sup>.

192. **Municipal public enterprises in particular demonstrated significant weaknesses in adhering to the Public Procurement Law.** According to the PPA, noncompliance is often attributable to municipal enterprises.

---

<sup>54</sup> The PPA did organize seminars on application of the law, which were attended by large numbers of LGs staff. Obviously this activity needs to be continued in the future.

193. **The new Public Procurement Law and its enforcement are rated positive, but with areas for improvement.** The consensus among stakeholders is that the law and its application can be considered successful but some parts of the law appear to be overly ambitious and too rigid. Secondary legislation has not been passed yet, while amendments to the law are planned for 2014. It should be noted that the law introduced some new procurement methods, application of which might be difficult for local entities.

## Public Property

194. **An issue common to all the audit reports reviewed was failure to maintain a complete and accurate inventory of fixed and financial assets.**<sup>55</sup> In all cities reviewed for this report, property owned by legal entities is undervalued and not fully recorded. As described in the accounting and financial reporting section (and Chapter 3), since LGs did not legally own any property until changes were introduced by Law on Public Property (2011), a transition period will be needed for them to produce complete and accurate asset registries, which are a prerequisite for reliable and complete financial statements. Other challenges are to properly value those assets and establish clear formal and legal grounds for which LG entity should record on its books.

195. **In addition to the underreporting of fixed assets in the books, all the audit reports flagged a failure of the LG to accurately account for its investments in municipal enterprises.** If reported at all, equity investment in public enterprises is consistently underreported (see Chapter 3). From a financial management perspective, the fact that public investments in these enterprises are not reflected in the public accounts suggests that their valuation and financial worth are misreported.

196. **There are also potentially significant risks in terms of contingent liabilities arising from investments in municipal enterprises that need to be accounted for and properly managed.** Overall, the lack of effective LG oversight of the affairs of public enterprises (see Chapter 3) imposes on LGs an unmanageable degree of financial risk that cannot be adequately accounted for during budget planning and execution. LGs do not seem to have access to effective advice and guidance to address the financial problems of public enterprises—a situation that could worsen as these enterprises keep accumulating losses.

## 4.4. External Scrutiny and Oversight

197. **External oversight of local finances has to some extent improved over the last several years.** External scrutiny covers the role of private external auditors, the SAI, and parliaments in ensuring that government bodies meet their legal obligations and manage public resources as intended. The law requires LGs to submit to local parliaments annual financial statements, accompanied by an audit opinion. Commercial auditors conduct annual financial audits of LGs, but the auditors appointed are often not of satisfactory quality.

---

<sup>55</sup> See also Chapter 3.

198. **The SAI has been auditing LGs since 2010 and by March 2014 had published 59 audit reports.** The audits conducted by commercial auditors are financial, focusing on the accuracy of financial statements; the audits conducted by the SAI are broader, covering both finances and compliance with laws and regulations. The latest audited accounts of 24 LGs relate to 2012 final financial reports. So far SAI has identified a large number of deficiencies, but the situation has not yet improved significantly (findings from audit reports of PUCs are summarized in the Box 4).

199. **According to the SAI, LG follow-up on its audit recommendations is satisfactory.** LGs are supposed to report on implementation of audit recommendations no more than 90 days after the audit. So far, all such reports have been submitted on time to the SAI; 53 percent of the recommendations relating to audit of 2011 accounts were implemented, as were 64 percent relating to audit of 2012 accounts. Audited LGs have since improved collection of fees, more property has been registered, and many LGs have adopted capital investment plans.

200. **There is considerable external scrutiny of LGs, mainly by nongovernmental organizations.** A number of NGOs in Serbia are monitoring local as well as national public finances, such as the Coalition for Monitoring of Public Finances, Fiskalni Monitor, and Skockaj svoj budzet. Most LGs have websites where they post budget information. The MoF publishes a monthly report of the consolidated performance of local budgets.

#### **Box 5: Main Findings of Audits of Municipal PUCs**

One of the most common issues identified in SAI audits of municipal public enterprises is failure to comply with the Public Procurement Law in the sense that goods and services are procured without a formal public procurement process or direct negotiations are not sufficiently justified. Like LGs, most PUCs lack internal audit units and a functional system of financial management and controls.

Another serious weakness is that records of the assets of municipal public enterprises are not complete—another issue identical to that of LGs. Municipal public enterprises need a complete asset registry and proper valuation of all assets in order to have fully accurate accounts. Unless this problem is rectified, their financial statements do not present a realistic picture of their financial position.

There is also a failure to comply with the Law on Public Property in that data on public property in use by PUCs are not submitted to the Property Directorate of the Republic of Serbia. Often, too, capital of these enterprises is not registered with the Agency for Business Registries as required by the Law on Public Enterprises.

## **4.5. Conclusions and Recommendations**

201. **Though PFM in Serbia has improved considerably since 2001, implementation lags behind the pace of legislative reforms.** This report grouped issues into three broad categories related to the stage of the budget process: (1) budget planning and revenue management, (2) budget execution, and (3) external oversight.

202. **The current system of budget planning and revenue management suffers from (1) frequent changes of the legal framework, (2) excessive interference of the central government,**

and (3) delays in issuance of budget instructions. Budget execution needs, among other things, clarity about accounting standards, a unified financial management and reporting system, and a better system of commitment controls. External oversight would benefit from higher standards for private auditors and their reports.

203. **Obviously, there is a strong case for improved PFM.** Investing further in building up the financial management performance of LGs can improve the quality of services they deliver and provide room for greater efficiency and potentially for fiscal savings. This chapter attempted to identify challenges that need to be addressed, which can be summarized as short-term measures and medium-term (structural) reforms.

### *Immediate and Short-term Measures*

204. **Some measures do not require significant investment or major legal changes could bring immediate gains.** The following recommendations could provide significant benefits to LGs by improving financial management in the short term.

205. **The central government needs to give LGs more support in their efforts to improve PFM.** The MoF needs better arrangements for providing advice and support to LGs as they address such pressing issues as property registration and changes in the tax system; it should nominate a single contact person within the Central Harmonization Unit (and other relevant departments of the ministry) for matters important to LGs. In addition, the MoF and the Treasury might consider simplifying LG reporting requirements and eliminating conflicts between them.

206. **The MoF and representatives of LGs should consider opening discussions about the mechanism for penalizing misconduct of LGs** related to wage policy and other areas where reduction of transfer is a penalty. The aim would be on the one hand to introduce more flexibility and on the other to ensure that the rules are followed transparently.

207. **LGs could accelerate improvements to their PFM systems** by introducing internal audit units and completing asset registries; organizing a training and certification program on public procurement for procurement officials; and investing in capacity-building for budget accounting departments. Budget permitting, LGs could also explore options for upgrading their FMIS systems that serve other users satisfactorily.

### *Medium-term Reforms*

208. **The PFM legislative framework needs to be completed for both national and local governments.** The MoF needs to give priority to completion of the Law on Budget Accounting, and LGs need to focus on completing and updating rulebooks for internal processes and procedures. The MoF should also harmonize legislation in the area of financial reporting and make its different pieces consistent. Finally, the MoF should provide clear guidance on the accounting standards used and align the chart of accounts with those standards.

209. **The central government should make efforts to respect the system of intergovernmental fiscal relations and the budget calendar.** The LG budgeting process is

dependent on central government budget preparation, so discipline in respecting the budget calendar should start at the center. Most importantly, information on next year's transfer and wages policy should be provided to LGs on time. Changes during a fiscal year in transfer amount or other sources of revenues should be avoided.

210. **LGs can look for options to increase revenues by enhancing financial management.** They need to assess all taxes and fees allowed by law. They should also improve management of receivables by decreasing the amounts that are uncollected. Also, all revenue should be properly recorded and presented in financial statements.

211. **As discussed in Chapter 3, LGs need to improve their oversight of PUCs to better manage potential financial risks.** The central government should work with LGs to establish mechanisms for oversight of municipal public enterprises so that the financial risks associated with obligations from new borrowing and from contingent liabilities are managed effectively.

## 5. Conclusions and Recommendations

212. **Given its current fiscal position and a sluggish economic outlook, pursuing significant fiscal adjustment over the medium term is the only viable course of action for Serbia.** However, the adjustment will be successful only through the combined efforts of all levels of government, including LGs. This study was designed to explore options for efficiency gains at local level of government. It has identified three problems that jeopardize Serbia's LG finances: spending on wages has gone up to become the single largest expenditure item; a growing number of PUCs are losing money and are heavily dependent on financial support from LGs; and slack PFM prevents LGs from managing their resources efficiently.

213. **These three areas of inefficiency (the wage bill, PUCs and PFM) are interrelated.** LG spending on wages has ballooned because of weak PFM systems, and management and oversight of PUCs is ineffective. The lack of control over hiring and pay policies and financial management has exacerbated PUC inefficiencies. Haphazard application of existing laws, limited investment in capacity building, and lack of attention from the central government is a major cause of the flaws in LG PFM systems.

214. **Current economic conditions make it ever more urgent for LGs and PUCs to seize every opportunity to curtail overstaffing and overpayment.** The central government has tried to restrain the LG wage bill, but its efforts have been undermined by loopholes in the regulations and their ineffectual implementation. The MoF has never exercised the option to reduce transfers to LGs that have breached the law in this field. LGs themselves are neither systematically overstaffed nor is their staff significantly overcompensated, but a third of them are in breach of legal staffing ceilings set by the central government, and many hire temporary staff to bypass the ceiling. There is a slight wage premium for local LG employees compared to the private sector that is more pronounced for low-skilled staff categories. Overstaffing and overpayment in municipal enterprises is more obvious. Compared to the private sector, wage premiums are sizable in district heating and smaller but not insignificant in water and sanitation and SWM. Finally, by the standards of other European countries, both water companies and district heating companies are overstaffed.

215. **Because PUCs are inefficient and an increasing number of them are loss-makers, they need ever more financial support from LGs.** PUC inefficiencies are caused by several interrelated factors: the ownership of fixed assets used by PUCs is unclear; the governance of many PUCs is politicized and does not follow good practices; tariffs are often well below cost recovery and leave little room for investment; and support from LGs is often channeled inefficiently through development directorates. Reform of PUCs should address all these problems to allow more efficient provision of infrastructure services and to reduce the pressure on local budgets.

216. **Since 2001 there have been major improvements in the legislative framework governing PFM in Serbia, but the implementation of this legislation has been slow.** This report has identified weaknesses with LG budget planning and revenue management as well as with their budget execution and external oversight of their budgets. Budget planning and revenue management systems suffer from frequent changes in the law and interference by the central government. To improve budget execution, accounting standards need to be regulated, financial

management and reporting systems unified, and commitment controls reinforced. Raising the standards for private auditors and audit reports would in turn strengthen external oversight.

217. **Reforms are needed in all three areas.** The three chapters of the report propose a package of reforms, starting with the most pressing and extending into the medium to long term. Because the problems identified are linked, the proposed reforms should be implemented as a package. That should not only unlock significant efficiency gains and help balance local budgets, it will also improve the efficiency and quality of service to citizens; make budget planning more realistic; reduce arrears; and motivate LG staff. Also, by executing the proposed reforms, LGs would make a considerable contribution to the fiscal sustainability of the Republic of Serbia.

218. **LGs should take the lead in initiating and conducting the suggested reforms, but the central government needs to support them** through intensified work on institutional and legislative improvements. Previously, the central government to some extent neglected LG operations; many important laws and regulations were missing and new institutions did not provide adequate support to LGs. This was probably most obvious in the area of PFM.

219. **This report makes sector-specific recommendations but it also proposes reforms related to broader issues.** Thus, it discusses a role for the private sector in delivery of local services, calls for greater integration of local and central government policy measures, and discusses the general effectiveness of the budget system. The matrix in the executive summary groups sector-specific reforms for the short and medium to long terms.

## Literature

Filippini, M., N. Hrovatin, J. Zorić, (2010) “Productivity growth and price regulation of Slovenian water distribution utilities”, Zbornik radova Ekonomskog fakulteta, Rijeka, 2010, Vol. 28 (1); pages: 89-112

Inter-institutional Professional Network in Water Sector of Serbia (2014) “Serbia: Performance Benchmarks and Data Audit for 2008-2012”

Ministry of Finance, Republic of Serbia, (2013), Fiscal Strategy 2014-2016

Nenezić, D, B. Radulović (2012) „Analysis of Finance Options, Models, and Financial Support Measures for Public-Private Partnerships in Serbia“, FREN Quarterly Monitor No. 30 (July–September 2012), 62-72.

Laušev J. (2012) “Public Sector Pay Gap in Serbia During Large Scale Privatization”, Ekonomski anali, 2012, vol. 57, nr. 192, page 7-24

Ognjenovic, K. (2011) “Wage Differences between the Private and the Public Sector in Serbia: Some Evidence from Survey Data”, Balkan Observatory Working Papers 091

World Bank (2011), Serbia Country Economic Memorandum

World Bank (2013), Serbia Municipal Finance and Expenditure Review