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## External Audit of Public Finance in Function of Macroeconomic Stability

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# External Audit of Public Finance in Function of Macroeconomic Stability

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## Abstract

The generally accepted view is that to achieve macroeconomic stability and sustainable economic growth, good management of public finance is necessary. The concept of external audit of public finance, as a subject of research in this paper, is analyzed as an integral element of public financial management system, which significantly determines transparent, responsible, and stable functioning of the public sector in any economy. In accordance with the subject, the goal of the research is to emphasize the importance of external audit of the execution of budget at all levels of government in the process of achieving and maintaining macroeconomic stability, with a special focus on the Republic of Serbia. Recognizing the complexity of this subject matter, qualitative methodology is applied, based on the dominant application of method of analytical description. The paper concludes that external audit of public finance has potential effects on the reduction of budget deficit and public debt. Given that ministries and other state administration bodies know that their financial reports can be audited at any time, external audit has a preventive effect in terms of awareness-raising for greater responsibility with managing public funds. Furthermore, recommendations of the State Audit Institution, to the extent that they are implemented, contribute to saving and efficient use of resources in certain areas.

**Keywords:** external audit, State Audit Institution, public finance, budget deficit, public debt, economy

**JEL classification:** M42, E60, H60

## Introduction

Control of public expenditure and revenues is made through a system of internal control, budget inspection, internal audit, and external audit of the final budget report. The need for the introduction of various forms of public finance control in modern countries emerged under the influence of demands for transparency, accountability, and economical use of public sector resources.

The audit of public finances or state audit refers to parliamentary control over budget allocation and spending (Leko et al., 2007). It is an indispensable part of a regulatory system, whose aim is to detect deviations from the accepted standards of financial management of public funds.

Thus, the concept of external audit of public finances, as the research subject of this work, shall be considered as an integral element of public financial management system, which significantly determines transparent, accountable, and stable functioning of the public sector in any economy. Accordingly, the goal of the research is to highlight the importance of external audit of budgetary spending at all levels of government in the process of achieving and maintaining macroeconomic

stability, with particular reference to the Republic of Serbia. Based on the research subject and objective, the work will test the following hypothesis: through examination and evaluation of legality, efficiency, and cost-effectiveness of public financial management, state audit is an important factor in maintaining macroeconomic stability, economic growth, living standard, and social welfare.

The structure of the work, in addition to introduction and conclusion, consists of three parts. The first part will explain the conceptual framework of state audit, with reference to its subject matter and reports drawn up by state auditors. Then, the second part of the paper will present responsibilities of the state audit in the Republic of Serbia. Finally, the third part of the paper will point out the problems of budget deficit and public debt faced by the Republic of Serbia, as well as the suggestions made in previous SAI reports.

## The conceptual framework of state audit

Generally speaking, the subject matter of state audit is public spending and revenues. More specifically, the subject matter of the state audit may be (The Law on the State Audit Institution – Article 9, Section 1):

- Income and expenses in accordance with regulations on the budget system and regulations on public revenues and expenditure;
- Financial statements, financial transactions, accounts, analyses, and other records and information on audited entities;
- Correctness of audited entities' operations in accordance with the law, other regulations, and powers;
- Appropriateness of public funds use in entirety or in a particular part;
- Financial management and control of budgetary system and other audited bodies and organizations;
- Internal control and internal auditing of accounting and financial procedures with auditees;
- Acts and actions of auditees that have or may have financial effects on income and expenditure of public funds beneficiaries, state property, borrowing and issuing guarantees;
- Correctness of management and governance authorities' work, and of other persons responsible for planning, execution, and supervision of public funds beneficiaries' operations, and
- Other areas prescribed by special laws.

External audit of the public sector ensures quality management of public finances in the following ways (INTOSAI, 2017):

- Provides beneficiaries to whom it is intended independent, objective, and reliable information, conclusion, and opinions;
- Strengthens efficiency of those bodies within constitutional arrangements that perform general monitoring and corrective functions of monitoring the work of the Government;
- Promotes accountability and transparency; and
- Creates incentives for change through the provision of knowledge, comprehensive analyses, and quality-based recommendations for improvement.

In Serbia, audit is conducted in accordance with the Law on SAI, SAI Rulebook, and International Standards of Supreme Audit Institutions (ISSAI). Those standards require compliance with ethical principles and audit planning and conduct to obtain reasonable assurance that final budget does not contain any substantially false information. State auditors may present one of the following four opinions in the

audit report: unqualified opinion, qualified opinion, disclaimer of opinion, and adverse opinion.

## Responsibilities of state audit in the Republic of Serbia

The basic institutional conditions for the work of the state audit are laid in the Lima Declaration, which implies that objectivity and effectiveness of state audit are achieved through its functional and organizational independence (Stanković, 2008). Section of the Constitution relating to economic planning and public finance states that realization of all budgets is controlled by SAI, as the supreme state body for auditing public finances, which is autonomous and independent in its work, and is subject to supervision by the National Assembly (the Constitution of the Republic of Serbia – Articles 92 and 96).

The Law on State Audit Institution regulates its powers in conducting external audit of public funds. The main tasks that fall within the purview of SAI can be grouped as follows (European Policy Center, 2012):

- Main activity: planning and conducting audit; audit reporting;
- Regulatory and related functions: adoption of bylaws and regulations in the field of public finance; adoption and publication of audit standards; determining examination programs for the acquisition of titles;
- Reporting: submitting reports to the National Assembly
- Expertise: providing expertise to the Assembly, Government, other public authorities, and public funds beneficiaries; and
- Other administrative tasks: organizing examinations for acquiring professional titles, keeping the register of such persons, international cooperation, and other activities.

SAI in the Republic of Serbia carries out three basic types of audit within its jurisdiction (State Audit Institution, 2017):

- Audit of financial statements – review of documents, official papers, reports, and other information in order to collect sufficient, adequate, and reliable evidence for expressing an opinion on whether the financial statements of the auditee give a true and fair view of its financial position, performance, and cash flows, in accordance with the accepted accounting principles and standards;
- Audit of regularity of operations – review of financial transactions and decisions regarding revenues and expenditures, in order to determine whether the underlying transactions are executed in accordance with the law, other regulations, given authorizations, and for the planned purposes; and
- Audit of performance – review of the budget and other public spending, in order to acquire sufficient, adequate, and reliable evidence for reporting whether the auditee's resources are used in accordance with the principles of economy, efficiently, and effectively, and in accordance with the planned objectives.

Effective implementation of the defined competences of state audit in Serbia affects the inflation curbing of public spending and creates a favorable environment for investment, which results in long-term monetary stability of the country.

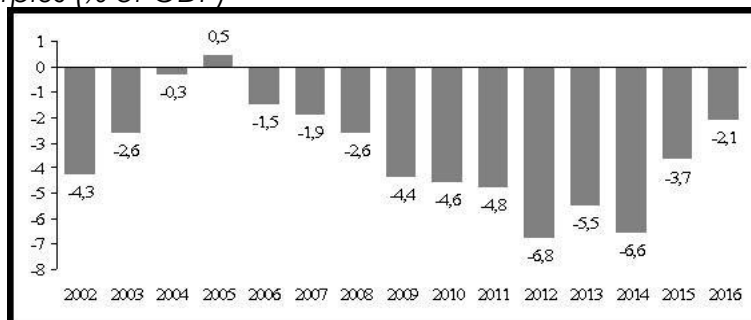
## State audit – a factor of macroeconomic stability of the Republic of Serbia

Given that macroeconomic imbalance can occur in different forms, such as large public deficit, exchange rate disorder, high level of external debt, higher or lower inflation rate, emergence of inflation tax as a revenue source of the public sector, large current account deficit, and high unemployment and public debt, it is reasonable to say that macroeconomic stability is a complex and multidimensional concept.

Public finances in Serbia during the first few years of transition were marked by a declining tendency of the share of fiscal deficit in GDP (Figure 1). After the surplus in 2005, the expansion of public spending caused the growing trend of the share of fiscal deficit in GDP. Serbia crossed the limit to fiscal deficit (3% of GDP), prescribed by the Maastricht convergence criteria (Afxentiou, 2000), in 2009. Fiscal consolidation measures produced good and important results in 2016. The general government deficit was brought below 3% of GDP.

Figure 1

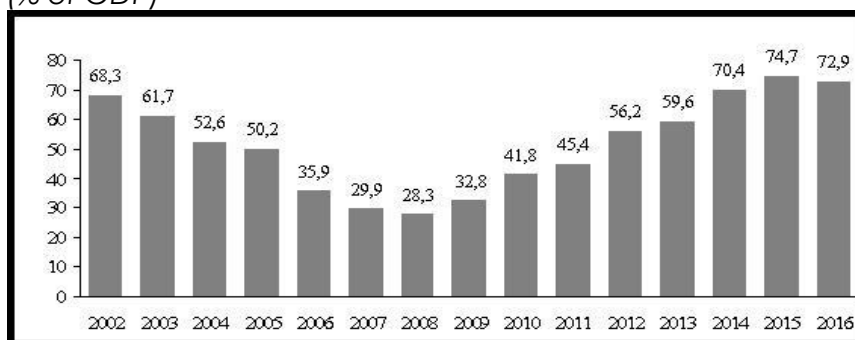
Fiscal Deficit/Surplus (% of GDP)



Source: Author, based on: Ministry of Finance of the Republic of Serbia, 2017

Bearing in mind that the growing fiscal deficit is a generator of growth of public debt, special attention must be focused on the share of public debt in GDP, as the main indicator of the level of indebtedness of the country. According to data of the Public Debt Administration, at the end of 2000, the total public debt of the central government was 169.3% of GDP. GDP growth, regular servicing of debts due from privatization receipts, write-off of debts to the Paris and London Clubs, and reducing the budget deficit influenced the decrease in debt ratio to 28.3% in 2008 (Figure 2). In the next period (2009-2014), Serbia increased borrowing to finance growing budget deficit. In 2011, the public debt exceeded 45% of GDP, which is the upper limit defined by the Budget System Law – Article 27e, Section 4. An additional warning is that the country's debt ratio in 2015 reached a value of almost 75%. This is above the upper limit of 60% of the public debt to GDP, as provided by one of the criteria for accession to the European Monetary Union (Afxentiou, 2000).

Figure 2  
Public Debt (% of GDP)



Source: Author, based on: Public Debt Administration, 2017

Higher public debt increases the risk of insolvency, limits the possibility of using fiscal policy as a tool in the fight against the economic cycle, and may increase the cost of borrowing for the government (Kapor, 2015). Finally, the growth of public debt can reduce economic growth and productivity.

The gradual decline in fiscal deficit in 2016 helped stop the growth of public debt to GDP for the first time since 2008. This lowered chances of public debt crisis, which was a real threat during the previous two years. However, it is necessary to bear in mind that the public debt is still very high (72.9% of GDP), and, it is, therefore, necessary to reduce it considerably more so Serbia could get closer to the prescribed, i.e. sustainable level of public debt.

Previous audit reports point to errors, irregularities, and falsely presented information, suggesting that there is a direct risk of making incorrect or irregular payment, or a risk that public funds are not being protected. In its reports, SAI continuously indicates that financial management and control of auditees are not fully organized in a way to ensure the implementation of laws, regulations, rules, and procedures, and to achieve other goals established in accordance with the law. Failure to establish financial management and control of budget funds beneficiaries causes certain irregularities in the spending of public funds and makes it difficult to monitor and control the system of budget planning and execution, i.e. financial plans of public funds beneficiaries.

In order to produce general observations on the system of external audit, interviews with certain auditees were carried out (European Policy Center, 2012). Most respondents said that the audit process was carried out professionally and in accordance with the law, and that they had long enough periods to comply with the recommendations of the audit report. Moreover, in most cases, SAI gave the maximum deadlines for elimination of irregularities and inappropriateness identified in the report. They said that they learned a lot during the audit process, and that, as a result, they now take much more rigorous approach to formal requirements in procedures such as public procurement and the like. However, it was estimated that the system of external audit (similarly applying to the system of internal audit) is not adequately linked with other reform processes in Serbia, especially with the process of public administration reform (European Policy Center, 2012).

They also expressed the need for the existence of some kind of "concerted practice", which SAI would recommend for certain aspects of auditees' financial operations. This would mean that SAI should, based on the experience gained from previous audit procedures, define their positions on certain practical issues that were or could be controversial in the audit process. Disclosure of such attitudes would significantly assist auditees in future full compliance and avoiding recommendations



for elimination of irregularities and inappropriateness in audit procedures. This SAI activity can be seen in the context of the advisory role, which SAI may carry out according to the Law on SAI (Article 5, Section 6).

## Conclusion

The public sector has an important role in all modern societies and economies. One of the main aims, and also the most difficult problem facing fiscal policy of every modern state, is to achieve budgetary balance, and then its maintenance. Therefore, establishing a good and efficient mechanism for external audit of budget spending is one way of preventive action towards achieving rational spending of taxpayers' money.

The paper presented the external audit of public finances in the Republic of Serbia, which is reflected in the work of SAI. The primary mission of SAI is to determine whether state authorities act in accordance with established financial reporting and accounting standards, and to timely detect indicators of abuse and send warning signs. SAI's independence is a basic requirement for the establishment of public accountability of all budget users for the management of public finances, and an important factor in preventing and detecting irregularities in spending public funds.

The main result of the state audit are expert and independent reports, which SAI submits to the Parliament, thus establishing an important link in the control of the executive, carried out by the legislature. The so far published reports on Serbian budget revision point to numerous irregularities in the spending of budget funds, as well as the lack of a stable system of internal audit in the audited entities.

Macroeconomic stability is the most important for the Republic of Serbia, i.e. ability to reduce deficit and control public debt. This can, among other things, be done by complying with the recommendations made in SAI reports. This creates an environment of accountable public administration, and makes room for a system of legal, efficient, effective, and economical use of public revenues. Consequently, responsible and transparent management of public finances is the basis of growth of living standard and social welfare.

Analysis of the current development stage of external audit of the public sector in Serbia suggests that, regardless of the distance traveled in recent years, which primarily relates to the constitution of SAI and giving it the role of monitoring and reporting on the work of the public sector as a whole, much remains to be done in developing external audit. In this respect, intensive efforts are necessary to make external audit actually the main instrument which reinforces responsibility of public funds users and restores confidence in the public sector. Auditees need to be more committed to working on the implementation of SAI measures. Also, the inclusion of SAI in the budget planning process in Serbia is an important element that determines its impact on the conduct of fiscal policy.

In order to overcome basic research limitations, reflected in the general review of the subject matter and competence of state audit, future research should focus on the analysis of effects of SAI. Given the importance of SAI as the most important mechanism that allows taxpayers to check how the government and other government authorities use public funds, future research should focus on in-depth analysis of the implementation of recommendations for removing shortcomings, irregularities, and unlawfulness of audited entities' work.

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