

## Budgeting in Croatia

by

Dirk-Jan Kraan, Daniel Bergvall, Iris Müller and Joachim Wehner\*

*Since 2000, three consecutive governments in Croatia have focused their policies on modernising the public administration and reforming the budget process. This article examines the budget process in Croatia in the light of its two unique characteristics: a very detailed account structure, and a large number of extra-budgetary funds and quasi-fiscal activities of public enterprises. The steps in the annual budget process are described, including the roles of specific actors (budget users, line ministries, the Central Government Treasury), and the limited role of Parliament in the formulation of budget policy. Regarding budget execution, procedures are in place for cash and debt management within the government units, and a central role is played by the Financial Agency that handles all government transactions. Recent decentralisation has resulted in increased responsibility for sub-national governments in service delivery, with repercussions on procurement. Financial relations between levels of government include procedures for tax sharing, equalisation, and grants. Audit and accountability activities are carried out on a modified accrual basis; external audit is done by the State Audit Office but internal audit capacity is currently being developed.*

\* Dirk-Jan Kraan and Daniel Bergvall are Project Managers in the Budgeting and Public Expenditures Division of the Public Governance and Territorial Development Directorate, OECD. Iris Müller is an Economist from German Technical Cooperation (GTZ). Joachim Wehner is Lecturer in Public Policy at the London School of Economics. The financial support of GTZ is gratefully acknowledged.

## Preface

This review of the Croatian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials of the OECD. The Budget Project aims to initiate and foster regional networks of senior budget officials outside the OECD area. This review served as a basis for the examination of the Croatian budget system at the second meeting of the network of Senior Budget Officials of Central, Eastern and South Eastern Europe (SBO CESEE), held on 16-17 February 2006 in Ljubljana. German Technical Cooperation (GTZ) is gratefully acknowledged for its contribution to the review and for its financial support.

A mission comprising Dr. Dirk-Jan Kraan (OECD Secretariat), Mr. Daniel Bergvall (OECD Secretariat), Mrs. Iris Müller (GTZ) and Mr. Joachim Wehner (London School of Economics) visited Zagreb in September 2005 to carry out the review. During its visit the mission met with Mr. Niko Raič, Assistant Minister for Budget Preparation, Mrs. Ivana Maletić, Assistant Minister for Budget Execution, and senior officials from various departments of the Ministry of Finance, and Mr. Željko Tufekčić, Assistant Minister, and other officials of the Ministry of the Sea, Transport and Development. The mission also met with Mr. Dino Bulešić, President of the Finance and Central Budget Committee of Sabor, the Croatian Parliament, with Mr. Jozo Serdarušić, Deputy Director for the State Audit Office, and with Mrs. Prof. Katarina Ott, Director of the Institute of Public Finance.

The mission would like to express its gratitude and appreciation for the cordial reception by the Croatian authorities and the frankness and openness that characterised the discussion with all Croatian officials.

Finally, the mission would like to thank Mrs. Ivana Jakir-Bajo, Head of the Budget Analysis and Capital Investment Evaluation Department, for the excellent organisation of the meetings and her unsparing help during the mission's stay in Zagreb, as well as Mrs. Ivana Vargasević and Mrs. Ana Michieli for their assistance to the mission and their efforts to collect documents and information that could be useful for the mission's aim.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

## 1. Introduction

### *1.1. General characteristics*

Croatia is one of the countries that have evolved from the dissolution of the former Yugoslavia. It gained its independence in 1990, but subsequently went through a tumultuous period of external and internal war in which the government, led by President Tuđman, gave relatively little attention to the reform of internal public governance. After the end of the Tuđman era the Constitution of 1990, as amended in 1992, was amended again in 2000 and 2001. The amendments of 2000 obliged the president to resign from membership in a political party after election and made the government answerable solely to Parliament and no longer to the President of the Republic. In view of this feature Croatia can now be considered as a parliamentary republic, rather than as a presidential or semi-presidential republic.

Since 2000 three consecutive governments have focused their policies on the modernisation of public administration and reform of the budget process with a view to joining the European Union as soon as possible. A first step in this process was the signing of the Stabilisation and Association Agreement with the EU in October 2001. In February 2003 Croatia applied to join the European Union and indicated its intention to join the second wave of EU enlargement foreseen for the accession of Romania and Bulgaria in 2007. After some delay caused by the concern of EU members about the lack of co-operation of Croatia with the International Criminal Tribunal for the former Yugoslavia in the Hague, the EU has recently decided that in view of changed Croatian policies towards the Tribunal, accession negotiations with Croatia could start.

Compared to the other countries of the former Yugoslavia, Croatia takes an intermediate position in regard to the progress of its reform process. Whereas Slovenia has focused since the first day of independence on the transition process, Croatia has made substantial progress only since the end of the 1990s. Other countries of the former Yugoslavia are in an even less favourable situation. However, given the relative late start of the focused reform efforts in Croatia, much has been achieved. The Constitution has been adjusted, administrative law has been reformed, sub-national government has been re-organised, and human resource management has been put on a modern footing with the new Law on Civil Servants and Public Employees. As far as the budget process is concerned the new Budget Act of 2003 (the organic budget law) has laid the foundation for a transparent and effective budget process. At the Ministry of Finance, young and competent staff have been recruited, who understand the priorities and

seem to be determined to sustain and accelerate the reform process. At the political level, there is presently no large difference of opinion between the major political parties, or between the government and the opposition, about the major direction of budgetary policy, although views on priorities within agreed constraints may mildly diverge. Under these circumstances, major further steps forward should be possible in the coming years.

With about 4.5 million inhabitants, Croatia is a relatively small European country. Although it has two layers of sub-national governments (counties and municipalities), sub-national expenditure is relatively low (5.6% of GDP in 2004). However, consolidated general government expenditures are relatively large (51.4% of GDP in 2004). This is far above the EU 15 average, surpassed only by the Nordic countries (Denmark, Finland, Norway and Sweden).

The same is true for the revenue side. Total revenues of consolidated general government in Croatia were at 46.5% of GDP (2004), resulting in a general government deficit of 4.9% (2004). However, like many transition countries in central, eastern and south-eastern Europe, Croatia has had strong economic growth in recent years. The slowdown that many EU countries have experienced from 2001 to 2004 has hardly affected the growth performance in Croatia. Spurred by strong internal demand, made possible by easy access to bank credit (91% of loans are provided by banks that are owned by foreign banking groups), and a booming tourism sector, GDP growth has been well above the EU 15 average since 2000 (see Table 1). Strong growth has contributed to increasing revenues, the more so because in view of the high deficit, Croatia has postponed some planned tax reduction programmes that might have spurred the growth performance even further, but would have been inconsistent with the consolidation effort in the public sector.

**Table 1. Growth in real GDP 1999-2008**

Per cent change on previous period

	1999	2000	2001	2002	2003	2004	2005 <sup>a</sup>	2006 <sup>a</sup>	2007 <sup>a</sup>	2008 <sup>a</sup>
EU 15	3.0	3.8	1.9	1.1	1.1	2.3	1.4	2.0	2.2	n.a.
Croatia	-0.9	2.9	4.4	5.2	4.3	3.8	3.9	4.0	4.4	4.3

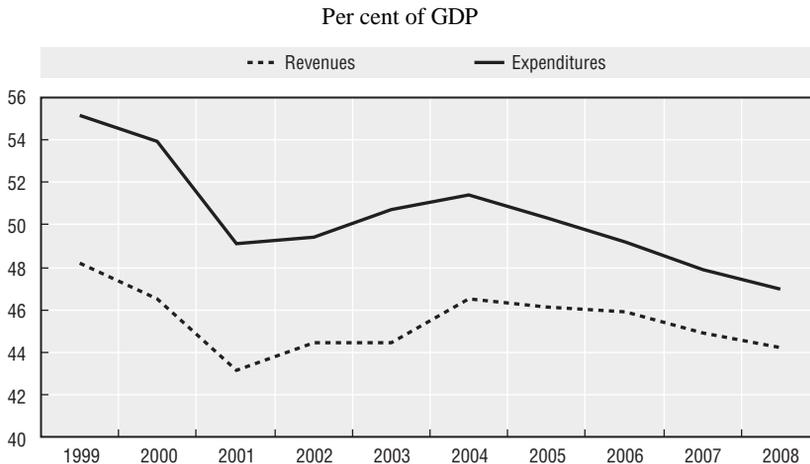
a. Forecast.

Sources: EU 15: Eurostat; Croatia 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; Croatia 2003-08: *Pre-accession Economic Programme (PEP) 2006-2008*.

The large general government sector and the high deficit in Croatia are to a large extent a heritage of the past. Since 2000, subsequent governments

have tried to steer the macro-budgetary indicators in the direction of the EU averages. Figure 1 shows the development of consolidated general government revenues and expenditures since 2000 and the planning numbers until 2008 to which the Croatian government has committed itself.

**Figure 1. General government expenditures and revenues 1999-2008**  
(excluding quasi-fiscal activities of public enterprises)



Note: 2005-07: forecast.

Sources: 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; 2003-08: *Pre-accession Economic Programme (PEP) 2006-2008*.

Table 2 shows the resulting general government deficit, excluding one-off capital revenues from privatisation in comparison with the EU 15 average.

**Table 2. General government deficits 1999-2007**  
(excluding quasi-fiscal activities of public enterprises)

Per cent of GDP

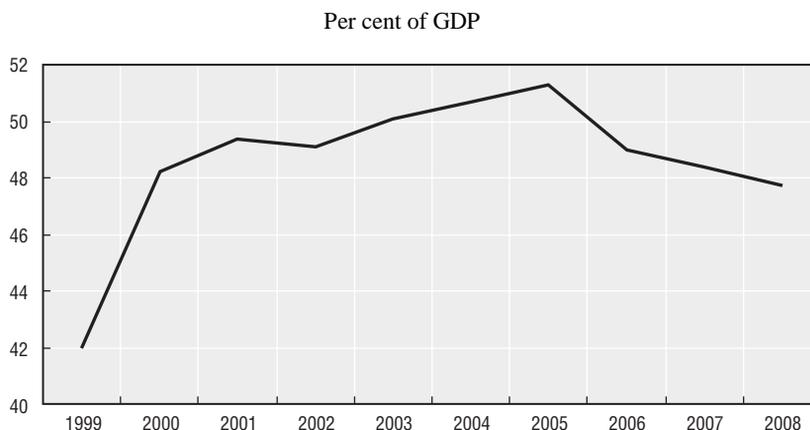
	1999	2000	2001	2002	2003	2004 <sup>a</sup>	2005 <sup>a</sup>	2006 <sup>a</sup>	2007 <sup>a</sup>
EU 15	-0.7	1.0	-1.2	-2.2	-2.9	-2.6	n.a.	n.a.	n.a.
Croatia	-7.0	-7.4	-6.0	-5.0	-6.3	-4.9	-4.2	-3.2	-2.8

a. Forecast.

Sources: EU 15: Eurostat; Croatia 1999-2002: *Annual Report of the Ministry of Finance 2002-2003*; Croatia 2003-07: *Pre-accession Economic Programme (PEP) 2006-2008*.

General government debt in Croatia in 2004 was at 44.8% of GDP, well below the ceiling of 60% imposed upon the euro countries by the Stability and Growth Pact, while public debt was at 50.7% of GDP. Public debt represents general government debt, *i.e.* the consolidated debt of central government (around 85% of general government debt), the extra-budgetary funds, and the local governments, augmented for the amount of guarantees. However, as can be seen from Figure 2, public debt has been growing in recent years at a rather fast rate. Partly this is due to a gradual improvement of registration, especially concerning debt of extra-budgetary funds, public enterprises and local government, as well as guarantees. Registration of guarantees (in 2004 about 12% of public debt) is still not perfect but, especially since the second half of 2003, the quality of the statistics has substantially improved.<sup>1</sup>

**Figure 2. Public debt 1999-2008**



Note: 2005-08: forecast.

Source: *Pre-accession Economic Programme (PEP) 2006-2008*.

## ***1.2. The transition process in Croatia***

OECD budget reviews look at the budget process. This comprises the budget institutions (the rules of decision making) and the way they function. Until the end of the 1990s the budget institutions and fiscal policies of Croatia fell short of the standards adhered to in OECD countries. Since the year 2000, however, subsequent cabinets have pursued with great energy

and perseverance fiscal and institutional policies directed at reform and modernisation and speedy accession to the EU.

These efforts were supported by the IMF, the EU and the World Bank. Croatia has twice concluded stand-by arrangements with the IMF, namely in February 2003 and in August 2004, not so much because of acute debt or balance of payments problems, but more for precautionary reasons and to signal its commitment to sound fiscal and structural policies.<sup>2</sup> Croatia has also committed itself to gradual adjustment of its fiscal and structural policies as part of the pre-accession economic programme agreed with the EU (Government of the Republic of Croatia, 2004a). Finally, the World Bank has long-standing relations with Croatia. In 2001 the World Bank approved a structural adjustment loan of USD 202 million and in 2005 a country financial accountability assessment of Croatia was published as basis for a potential programmatic adjustment loan (World Bank, 2005). The country financial accountability assessment focused on budgeting, treasury and cash management, accounting and financial reporting, internal control and internal audit, external audit and legislative oversight, financial accountability arrangements for sub-national government, and capacity development. Currently there are eleven World Bank active projects in Croatia totaling USD 447.6 million. The projects focus on infrastructure, railway management, the health system, the judicial system, the pension system, property administration (the cadastre) and energy policy.

The commitments made by Croatia in contracts with the IMF, the World Bank and the EU cover not only fiscal policies and structural financial-economic policies in general but also budget institutions, and are often the point of departure of the findings in this review.

### ***1.3. Fiscal policy and institutional reform in the recent past***

In order to put the findings of this review in perspective it is useful to provide some data at the outset about institutional and fiscal policy in the recent past.

In 2003 fiscal policy had not achieved its general government deficit reduction target (excluding quasi-fiscal activities of public enterprises) of 4.5% of GDP (IMF, 2004a). This was partly due to a sharp reversal of fiscal policy in the run up to the November 2003 parliamentary elections (see Figure 1). Additional spending led to an overrun of the general government deficit target of about 1% of GDP in 2003 (of which a half percentage point was for additional road construction). Moreover, the state-owned Croatian Bank for Reconstruction and Development (HBOR) provided additional loans for housing reconstruction, and the chronically money-losing state-owned Croatian Railways was directed to borrow additional funds under

government guarantee for both operating and capital expenses. If these quasi-fiscal activities are taken into account, the general government deficit in 2003 amounted to 6.3% of GDP.

Fiscal consolidation became a central objective of fiscal policy in the budget and supplementary budget<sup>3</sup> for 2004. The most important considerations in this respect were the necessity to close the gap between saving and investment in the domestic economy (leading to the deterioration of the balance of payments and rapidly increasing foreign debt) and the authorities' wish to bring the general government deficit within the boundary of 3% of GDP, which is imposed as a ceiling upon the euro zone countries. In particular the government wanted to bring back the general government deficit (excluding quasi-fiscal activities) to -4.5% of GDP in 2004 and to -3.7% of GDP in 2005 while simultaneously eliminating the general government payment arrears. The aim for 2004 was to be achieved through an increase in revenues (one-off dividend payments from public enterprises and receipts from the sale of GSM licenses, increase in excise rates on cars and tobacco) and to a lesser extent reduction in investment expenditures (especially in the motorway and road agencies).

In the 2004 supplementary budget it was announced that for 2005 and the longer term the government wanted to enhance tax collection (in part through establishment of the financial police), limit borrowing by local government, and take measures to control health spending. In the institutional sphere the government wanted to bring all financing of the extra-budgetary funds of Croatian Railways and of the Croatian Bank for Reconstruction and Development (mainly loans for housing reconstruction) on budget. In addition the authorities intended to control contingent liabilities by keeping the nominal stock of guarantees from increasing during 2004-05. Finally, the authorities intended to formulate a medium-term fiscal plan as part of the 2005 budget in which an annual general government deficit reduction of 0.5% of GDP would be announced until the deficit would be below the 3% ceiling. The process of harmonisation with EU legislation would require substantial adjustments in spending priorities in the medium term.

Policy implementation in 2004 was broadly in line with the (supplementary) budget with the exception of the general government deficit and the reduction of the general government arrears. The 2004 general government deficit (excluding quasi-fiscal activities of public enterprises) was reduced to 4.9% of GDP instead of 4.5% of GDP due to slippage in tax collection and a shortfall of some one-off revenues (particularly dividends from the telecom company). Total expenditure was on target. The reduction of the general government arrears fell short of the target, mainly because of an increase in arrears in the health sector (payments to hospitals). This

increase may have been due to better registration and was symptomatic of more fundamental problems in the finances of the health sector. At the end of 2004 the total outstanding stock of arrears stood at 0.7% of GDP.

The 2005 budget was accompanied by a multi-annual macroeconomic and fiscal framework. The framework was put up in accordance with a pre-accession economic programme prepared for EU accession. The general government deficit target for 2005 was adjusted to 3.7% of GDP (due to the slippage in 2004) and was set at 3.2% of GDP for 2006 and 2.9% of GDP in 2007. The presidential elections in early 2005 and local elections in May 2005 weakened the government's focus on economic policies, but since then policies have been back on track with a less ambitious fiscal target but a significantly strengthened structural agenda. The original deficit target of 2005 had to be abandoned because of a shortfall in tax collections, expenditure overruns in entitlement programmes, and the postponement of the change in the indexation formula for public pensions that had already been incorporated in the original 2005 budget to compensate for additional spending on EU harmonisation programmes.

In July 2005 Parliament approved a supplementary budget with a revised deficit of 4.2% of GDP, additional one-off measures at the revenue side (dividends of public enterprises), and an increase in the ceiling for debt guarantees (needed for the restructuring of the state-owned shipyards). The revised budget contained additional structural measures: a new Civil Service Law; introduction of co-payments in the health sector as a first step to comprehensive health reform; curbing housing subsidies, employment subsidies and state aid to industry; promulgation of the delayed change in pension indexation; introduction of a 10% VAT rate on all tourist accommodation (thus eliminating the present 0% rate). The government also announced its intention to strengthen financial discipline in the broader public sector by better control of guarantees and restructuring Croatian Railways. Despite legal delays, the privatisation process will be pursued until all remaining government holdings in the Privatisation Fund are sold. The World Bank's programmatic adjustment loan will support this process. Finally, the government announced its intention to settle the "pensioners' debt" during the period 2006-13. This debt originated from a 1998 decision of the Supreme Court ruling that the state was liable for unpaid pension indexation entitlements during the period 1993-98. The pensioners' debt was estimated at 6.2% of GDP in 2005.

On many of the institutional issues addressed by the Croatian Government in the last few years, progress has been made in 2005 and especially during the preparation of the budget 2006. However, as the present report makes clear, there is still much to do, and the transition process in Croatia is by no means completed.

## 2. Budget formulation

### *2.1. Key characteristics of the Croatian budget process*

It should be mentioned at the outset that the Croatian budget has two features, which differentiate it from most OECD countries:

- First the Croatian budget has a very detailed account structure, but still maintains some flexibility through a provision in the Budget Act that allows reallocation during budget execution and a legislative device called the Law on Budget Execution.
- In Croatia there are a large number of extra-budgetary funds and quasi-fiscal activities of public enterprises which are mostly reported in general government accounts in accordance with IMF standards, but which are not fully integrated in the decision-making process on budget formulation.

### *2.2. Detailed account structure*

The budget classification of Croatia is very detailed. It contains approximately 7 000 line items which are determined by economic, organisational and programmatic dimensions. In recent years there has been a tendency towards more emphasis on programmatic considerations, but this has so far not led to a reduction of economic and organisational distinctions.

Although the budget is decided on a very detailed level, the government is given large authority over reallocation of expenditures during the execution phase of the budget. Rules regarding reallocation of expenditures are laid down in the Budget Act (Article 38) and the annual Law on Budget Execution. The passing of a special Law on Budget Execution is not usual in OECD countries, but also occurs in Slovenia (OECD, 2004).

Rules for reallocating expenditures do not differ between the reasons for reallocation, like forecast errors, changed macroeconomic conditions and new spending priorities, but instead apply to the size of the reallocation. Three different types of reallocation can be identified:

- Reallocation of less than 5% of a line item estimate;
- Reallocation of more than 5% of a line item estimate, but still within total government expenditure; and
- Reallocation that increases or decreases total budget expenditure.

The first two types of reallocation can be made without the approval of Parliament. If a budget user wants to reallocate an amount that is less than 5% of a line item estimate, it can do so after the approval of the minister of finance. Reallocation of more than 5%, but still within the budget total can be reallocated with the permission of the government. Reallocation that increases or decreases the budget total can only be made by supplementary budget. However, repayment of public debt and interest payments on public debt can be made in amounts exceeding the approved budget items without any permission. Furthermore, funds may not be reallocated between revenue/expenditure accounts and financial accounts<sup>4</sup> except with authorisation in the Law on Budget Execution. This law also sets the term within which Parliament has to be notified of reallocation (in 2005, within 15 days).

There has been reluctance in Parliament to reduce the number of line items in the budget. Parliamentarians like to see “their” items included in the budget, even if they are for small amounts and obscure the perspective on the purpose of broader categories of spending. This can be seen as contradictory, as the government at the same time has large autonomy in reallocating expenditures during budget execution. The Ministry of Finance is aware of the desirability of reducing the number of line items and moving towards a more programmatic budget classification focused around programme objectives, but so far little has been achieved in this respect. Presently it is recognised in the Ministry of Finance that progress in this direction can only be made by a general change of attitude, starting in the line departments. Only if line departments start providing reliable information on performance and results, not necessarily in the budget but in any case in plans and evaluations of line ministries, can Parliament gain the confidence that is a precondition for a substantial reduction of line items.

### ***2.3. Extra-budgetary funds and quasi-fiscal activities of public enterprises***

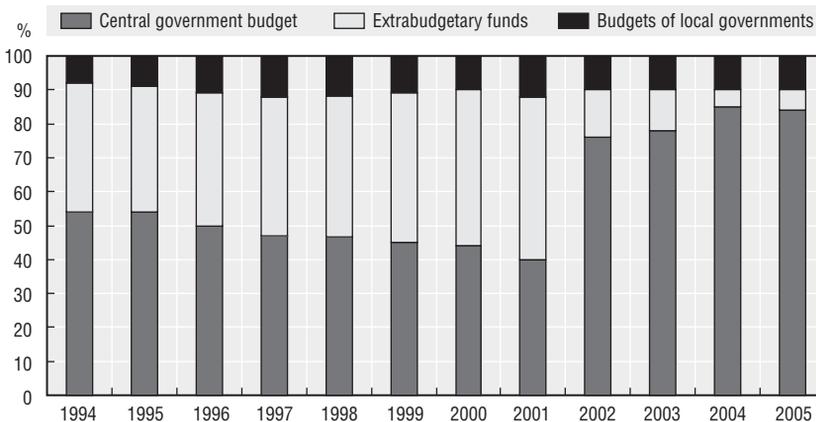
The universality and unity of the budget has been a major issue and area of reform in Croatia in recent years. The principle of universality requires that all revenues and expenditures under the control of the central government are authorised by the government and Parliament. The principle of unity requires that all revenues and expenditures are authorised in the same document so that all trade-offs can be considered during executive and legislative budget formulation.

In the past these principles were compromised by extensive use of extra-budgetary funds and quasi-fiscal activities of public enterprises. Extra-budgetary funds can undermine budgetary discipline if only the net

payments from the central government budgets to these funds are reported in the budget (rather than the gross payments and revenues of the funds themselves, including the earmarked revenues and fees that flow directly into the funds rather than into the central government treasury). Furthermore, budgetary discipline is undermined if extra-budgetary funds can engage in borrowing and lending or can provide guarantees without regular appropriation controls. Quasi-fiscal activities undermine budgetary discipline if public enterprises can sell below market price because they receive special favours such as tax exemptions, regulatory protection, soft loans, or guarantees without regular appropriation controls.

In recent years Croatia has made considerable progress in the integration of extra-budgetary funds into the budget (see Figure 3). Some of the funds are brought under the Treasury Single Account and are brought within the budget prioritisation process.<sup>5</sup> Two other major extra-budgetary funds, namely the Development and Employment Fund (for redevelopment of war-affected regions) and the Regional Development Fund which were established in 2002 and took over a number of tasks that were previously funded from the state budget, were integrated again in the budget as of 2003 (not as budgetary funds but as parts of the state budget). Other funds however remain outside the Treasury Single Account system and the budget decision-making process<sup>6</sup> although their budget estimates are included in the budget (not for authorisation but for information purposes) and their realisations in financial reports.

**Figure 3. Expenditures of the general government budget 1994-2005**



Note: 2005: forecast.

Source: Bajo (2005).

More than half of the expenditures of extra-budgetary funds in 2003 were made by the motorway fund (see Table 3). This fund covers only one-quarter of its expenditures by earmarked taxation on cars and gasoline and is mainly funded by net transfers from the state budget.

Croatia has a large sector of public enterprises compared to economies of similar size. This too is a heritage of the past. For instance, the Croatian Privatisation Fund manages a portfolio of more than 1 100 companies outside the financial and utility sectors. There are no clear rules for profit transfers from the public enterprises to the state budget. Dividends are currently determined by the enterprise and the Privatisation Fund. Dividends are retained by the Privatisation Fund as its own revenues and only returned to the state budget as part of a surplus of the Privatisation Fund at the end of the year. The Privatisation Fund itself is an extra-budgetary fund. Its revenues and expenditures are not subject to the appropriation controls of the budget process. Another public enterprise is Croatian Railways, which suffers large losses due to restrictive price regulation, but is protected by extensive soft loans and guarantees.

**Table 3. General government expenditures and extra-budgetary funds in 2003**

Per cent of GDP

<b>State budget</b>	<b>41.0</b>
<b>Extra-budgetary funds</b>	<b>6.4<sup>a</sup></b>
Pension Fund	1.0
Health Insurance Fund	0.5
Employment Fund	0.1
Croatian Waters	0.9
Croatian Motorways	2.9
Croatian Roads	0.8
State Agency for Deposit Insurance and Bank Rehabilitation	0.1
Croatian Privatisation Fund	0.2
<b>Regional and local government</b>	<b>5.4</b>
<b>General government</b>	<b>52.8</b>

a: Rounded figures.

Source: IMF (2004b).

In the financial sector, the state owns (apart from the central Croatian National Bank) two small commercial banks (Postansk Bank and Croatia Bank) as well as the large Croatian Bank for Reconstruction and Development (HBOR). The HBOR was established in 1992 with a starting capital of HRK 3.7 billion (Croatian kuna) to finance housing reconstruction and development in war-affected areas. Its role is extensive and comprises housing loans, business start-ups, infrastructure development and export finance. Many HBOR activities are covered by government guarantees.

Quasi-fiscal facilities enjoyed by the publicly owned banks include soft loans and guarantees, tax exemptions<sup>7</sup> and regulatory protection.<sup>8</sup>

There is no clear division of tasks concerning the oversight of the extensive public enterprise sector. The roles of the line ministries, the Ministry of Finance and the Privatisation Fund are not clearly defined.<sup>9</sup> It is important that the rules in this respect are clarified and that budget users are made accountable for the financial management of the public enterprises under their supervision and for the speedy elimination of quasi-fiscal activities.

#### ***2.4. Annual budget process***

In Croatia the annual procedure for budget formulation was established in the Budget Act of 2003. It prescribes and regulates among other things: the time schedule and procedures for the preparation of the economic forecasts; and the subjects to be treated in budget guidelines and in the financial plans and development programmes of the line ministries and the budget users.

Budget users are divided into three levels. First-level budget users are ministries (13) and public law agencies (37). Second-level budget users are sub-units within ministries or agencies (31 units), and third-level budget users are lower-level budget beneficiaries such as schools, theatres, courts, etc. (approximately 720 units).

The fiscal year in Croatia coincides with the calendar year. The main steps in the process are indicated in Table 4 and described below.

Annual budget formulation starts with the release of the spring economic forecasts by the Ministry of Finance. The macroeconomic forecasts are prepared increasingly with the use of a consistent framework and a range of sectoral and macroeconomic data, including data from other European countries, which are of vital importance to Croatia's economic development. The forecasts also take account of the impacts of the governmental programmes (indirect effects). The Macroeconomic Analysis and Forecast Bureau is responsible for the macroeconomic forecasts. With support from the United States (Agency for International Development, USAID) it has established a macroeconomic model. The forecasts are established in co-operation with the Croatian National Bank. In the Macroeconomic Analysis and Forecast Bureau, nine economists are employed in three sections, one in the macroeconomic forecast section, one in the public debt issues section, and seven in the fiscal section; the latter is responsible for the projections of revenues and expenditures. The

macroeconomic forecast section seems to be understaffed and, with only one official who is able to use the macroeconomic model, rather fragile.

**Table 4. Budget formulation**

Due dates	Activities	Legal basis
End April	Medium-term economic and fiscal outlook prepared by the Ministry of Finance and presented to the government.	Article 18 (2)
15 May	Government enacts budget guidelines.	Article 18 (4)
End May	On the basis of the guidelines, the Ministry of Finance issues instructions to budget users and extra-budgetary users of the state budget, and to local and regional self-government units, for the development of budget proposals.	Article 20 (1,3)
End June	Budget users deliver their financial plan proposals to the responsible ministry.	Article 22 (2)
July-October	The Ministry of Finance reviews the proposals and reconciles them with the estimated revenues and receipts. Detailed negotiations between the Ministry of Finance and the line ministries.	Article 30 (1,3)
15 October	The Ministry of Finance prepares the draft state budget including the draft consolidated budget and delivers it to the government.	Article 30 (2)
End October	Government deliberation and decision on final budget proposal, on the basis of proposals from the Ministry of Finance and line ministries.	Administrative
15 November	The government or the local executive authority delivers the budget proposal and the consolidated budget to the Sabor (Parliament) or to the local representative council for adoption.	Article 30 (5)
End December	The Sabor or the local representative council passes the budget. The approved budget is published in the <i>Narodne Novine</i> (National Official Gazette).	Article 32 (1,3)

On the basis of macroeconomic projections, the Ministry of Finance develops the draft guidelines for economic and fiscal policies for a three-year period starting with the budget year. These guidelines have to be submitted to the government by the end of April. According to Article 18 of the Budget Act, these guidelines should include:

- Prerequisites for social and economic development in the budget year and the following two years;
- Basic indicators of fiscal and economic policy;

- An estimate of realisations of revenues and expenditures of all first-level budget users in the current year (prior to the upcoming budget year) and the previous year;
- A broad proposal for the financial plans for the upcoming budget year, the following budget year and the following two years at the level of first-level budget users;
- Projected changes in the state assets and assets of local and regional self-government units, and the debt of the local and regional self-government;
- A global overview of the assumed state budget obligations that have to be paid in the following years;
- A development plan including investment programmes in the medium and long term.

The guidelines are drafted under the responsibility of the minister of finance and should be adopted by the government by 15 May.

In the Central Government Treasury, the Budget Preparation Sector is divided into three departments: budget analysis (staff of four); budget preparation (staff of eight); and local governments (staff of four). All units are understaffed in comparison to the official staffing level. The government seems to have significant problems recruiting and maintaining qualified staff, who tend to move on to better paid jobs in the private sector. This is a serious problem and will continue to be so if nothing is done. An overall strategy in this field is urgent, as maintaining qualified junior and senior staff is important to keep up the momentum of reform.

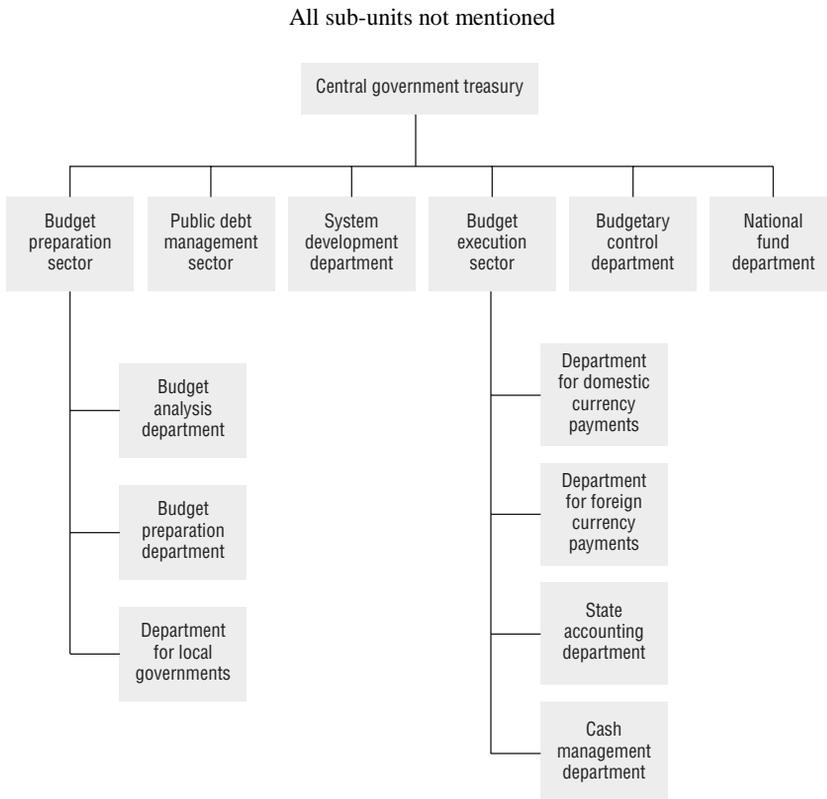
On the basis of the adopted guidelines, the Ministry of Finance draws up instructions for the development of the state budget proposal and sends them to the first and second-level budget users and users of extra-budgetary funds by the end of May. These instructions should include the basic economic assumptions from the guidelines and budget targets for the upcoming budget year and the following two years. Furthermore the instructions should include the time limits for the budget formulation process.

The budget users have to develop their financial plan on the basis of the instructions and send them to the Ministry of Finance by the end of June. According to Article 21 of the Budget Act, the financial plans must include:

- Revenue estimates by types;

- Expenditure estimates for the three-year period, classified according to the budget classification prescribed in the Budget Act and ensuing instructions of the Ministry of Finance;
- An explanation of the financial plan;
- Development plans of investment programmes in the medium and long term;
- Procurement plans;
- The planned number of staff for the three-year period in accordance with law and by-laws.

**Figure 4. Organisation of the Central Government Treasury**



According to Article 22 of the Budget Act, the explanations of the financial plans should include:

- A statement of reasons for programmes in a particular area;
- Legal and other backgrounds of programmes;
- The targets of the programmes and the underlying policy strategies, harmonised with the development plans;
- The indicators on which the estimates are based;
- A report on the results achieved in the programmes in the previous year;
- Other statements of reasons (explanations) and documentation.

The harmonised financial and development plans of the first-level budget users have to be transmitted to the Ministry of Finance by the end of June. Between July and October the Ministry of Finance negotiates the financial plans with the line ministries and revises them according to the conclusions. If during the negotiations a disagreement occurs between the Ministry of Finance and a budget user, the minister of finance prepares a statement for the prime minister who makes a final decision.

By 15 October the minister of finance prepares the draft state budget including the draft budget of consolidated central government and submits it to the cabinet. The cabinet makes final decisions. Given the fact that disagreements between the minister of finance and line ministers have already been arbitrated by the prime minister during the summer, it seems that line ministers have little chance of gaining additional funds at this stage, unless they can claim that entirely new developments have occurred.

Croatia does not have an explicit fiscal rule for the total or current deficit. Instead, it relies on an expenditure and revenue strategy that aims to keep the deficit within acceptable boundaries. For a few years this strategy has also been explicitly placed in a multi-annual fiscal framework that aims to reduce the consolidated general government deficit below the 3% margin that is enshrined in the Stability and Growth Pact of the euro zone countries. This is a common practice in many OECD countries as well. However, what is still largely lacking in Croatia is a clear top-down steering of the budget process aimed at the enforcement of the multi-annual strategy. The budget is drawn up from year to year without much consideration of the multi-annual framework adopted in the previous year. Even if Croatia is perhaps not yet at the stage where it can use unalterable multi-year expenditure ceilings such as prevail in the Netherlands, Sweden and the United Kingdom, it could at least pay more attention to the explanation internally and externally of the annual changes in the multi-annual fiscal framework. The Ministry of Finance could for instance explain more clearly in the budget guidelines and in the budget submitted to the Sabor how the expenditure ceilings for the

budget year and the two following years are related to the expenditure ceilings that were announced in the previous budget and the reasons for the changes.

The budget for 2005 contained for the first year the multi-year line item estimates prescribed in the Budget Act. The role of these estimates is so far not very clear. Presumably they are based on current policy (including policies decided but not yet implemented) rather than current law.<sup>10</sup> However, a real multi-annual budget process can only succeed if the multi-year estimates are taken very seriously. They should be updated from month to month at the line item level and be monitored continuously by the Budget Preparation Sector of the Ministry of Finance.

### **Box 1. Budget formulation in the line ministries**

The budget cycle of line ministries starts by the end of May, when the Ministry of Finance issues instructions to line ministries and budget users for the development of the state budget proposal. The line ministries also prepare additional information for the budget users. Both the information from the Ministry of Finance and the additional information from line ministries shall be transmitted to budget users. The budget process within the line ministries is a bottom-up process.

When budget users deliver their financial plans and development plans to the responsible ministries, bilateral discussions start within the ministries. Financial plans of second and third-level budget users situated under the ministry have to be discussed and agreed with the representatives of these budget users. Afterwards, the proposals should be sent to the ministers and state secretaries and then to the Ministry of Finance.

Since policy changes and saving measures often take a long lead period before they are reflected in budget estimates, it is important that all policy discussion in the government (and not only budget policies) is supported by accurate information on multi-annual consequences and the required changes in multi-annual estimates. In many OECD countries this requirement is put in practice by an obligatory form about multi-annual budgetary consequences that should be attached to all policy proposals submitted to the government and without which a proposal cannot be considered.

In general, budgetary discipline during budget formulation could be further strengthened. In this respect it is important to make a clear distinction between the multi-annual expenditure totals of first-level budget

users and line item estimates. Expenditure totals should be enforced rigorously from year to year during budget formulation as well as during budget execution. Unexpected developments, including overspending on entitlement programmes, or new spending priorities should be accommodated by reallocation within the totals or saving measures. Line item budgetary and multi-annual estimates can be flexible but totals of first-level budget users should be as inflexible as possible. The enforcement of the totals is a crucial task of the minister of finance and the prime minister. In this respect further progress should be made in the coming years.

It is important that the budget documents explain carefully from year to year how the budgetary and multi-annual line item estimates relate to the multi-annual estimates of the previous year. In particular it is important that information is given about the reasons for the changes. Do they originate in new forecasts about entitlement spending on the basis of existing legislation or in policy changes? If the latter, how are the policy changes accommodated within the multi-annual fiscal framework? Which saving measures have been decided to make room for new spending priorities? Presently this information is largely lacking, which makes it difficult for Parliament and civil society to assess the budget proposals of the government.

In order to strengthen budgetary discipline it is also important that extra-budgetary funds are fully brought under the regular appropriations controls, either by integrating them in departmental budgets or by integrating them as separate funds in the budget. In a first stage this would not necessarily imply that their expenditures and revenues are brought under the Treasury Single Account system as this might involve technical complications that could take some time to resolve. It would imply however that the revenues and expenditures of extra-budgetary funds are reported on a gross basis in the budget documents and can be subject to trade-offs during budget deliberations on the same footing as other revenues and expenditures in the state budget.

Like in many OECD countries, the Croatian Parliament approves the budget on a cash basis, but in the explanatory budget documents the government presents a consolidated central government budget balance on a commitment basis (in accordance with the Government Finance Statistics of the IMF; IMF, 1986 and 2001) and a consolidated general government budget balance on a commitment basis. However, in the budget documents (as opposed to the retrospective financial reports, see section 5 below) there is not yet a fully transparent explanation of how the budget balance on a commitment basis is derived from the budget balance on a cash basis, nor how the consolidated general government balance is derived from the consolidated central government balance. In the latter respect it is

particularly not transparent how extra-budgetary funds, quasi-fiscal activities of public enterprises and cumulative changes in the stock of arrears are taken into account. However, in the absence of such information, it is difficult for Parliament to assess the general budgetary strategy in the context of the medium-term fiscal framework.

In Croatia no attempt has yet been made to estimate tax expenditures and to present them in a separate survey in the budget documents. This is not an easy exercise. Nevertheless many OECD countries have started reporting tax expenditures in the budget documents in order to facilitate a more rational use of this instrument and to allow trade-offs with other expenditures (Kraan, 2004).

### **Box 2. The Institute of Public Finance**

The University of Zagreb founded the Institute of Public Finance, a research institution specialising in public finance, in 1970. It employs ten researchers, one librarian, two editors and two administrative staff.

Today's Institute of Public Finance is a public non-profit institution that undertakes research into all aspects of public sector economics, *e.g.* public sector expenditure and revenue, fiscal policy, budget policies, public debt, and the role of the state in the economy. In addition to economic research, the Institute specialises in publishing work related to public sector economics.

The Institute of Public Finance has regular contacts with numerous foreign institutions and associations.

In general the transparency of the budget documents in Croatia has increased considerably in recent years, but it is important that further steps be taken. This will further stimulate the debate about budgetary priorities, not only in Parliament but also in the press and civil society. In this respect a very useful role has been fulfilled in recent years by the Institute of Public Finance, which is an independent Croatian think tank and research institute that has focused on budgetary policy and has published many important studies.

## **2.5. Conclusion**

The Croatian budget has a very detailed account structure with approximately 7 000 line items, but still maintains some flexibility through a provision in the Budget Act that allows reallocation during budget execution and a legislative device called the Law on Budget Execution. There has been

reluctance in Parliament to reduce the number of line items in the budget. The Ministry of Finance is aware of the desirability of reducing the number of accounts and of moving towards a budget classification focused around programme objectives, but progress in this direction can only be made by a general change of attitude, starting in the line departments. Only if line departments start providing reliable information on performance and results can Parliament gain the confidence that is a precondition for a substantial reduction of line items.

In Croatia there are a relatively large number of extra-budgetary funds. In recent years there has been considerable progress in the integration of extra-budgetary funds into the budget. However, a number of funds remain outside the Treasury Single Account system and the regular appropriations controls of the budget process. It is important that these funds are also integrated in the budget. If it takes some time to bring these funds under the Treasury Single Account because of technical complications, a first step could be to include the revenues and expenditures in the budget on a gross basis so that they become subject to the regular appropriations controls and so that trade-offs with other revenues and expenditures can be considered during budget deliberations.

Croatia has a large number of public enterprises, many of which engage in quasi-fiscal activities. There is no clear division of tasks concerning the oversight of public enterprises between the line ministries, the Ministry of Finance and the Privatisation Fund. It is important that the rules in this respect are clarified and that budget users are made accountable for the financial management of the public enterprises under their supervision and for the speedy elimination of quasi-fiscal activities.

The government seems to have significant problems in recruiting and maintaining qualified staff. This is a serious problem and will continue to be so if nothing is done. An overall strategy is urgent as maintaining qualified staff is important to keep up the momentum of the reform process.

Croatia does not have an explicit fiscal rule but instead relies on a medium-term expenditure and revenue strategy that aims to keep the deficit within acceptable boundaries. This is common practice in many OECD countries as well. However, what is still largely lacking in Croatia is a clear top-down steering of the budget process aimed at enforcement of the multi-annual strategy. It would be useful for the Ministry of Finance to explain more clearly in budget guidelines and in the budget documents submitted to Parliament how the expenditure ceilings for the budget year and the two following years are related to the expenditure ceilings that were announced in the previous budget and the reasons for the changes.

The budget for 2005 contained for the first time the multi-year estimates at the line item level prescribed in the Budget Act. The role of these estimates is so far not very clear. A real multi-annual budget process can only succeed if the multi-year estimates are taken very seriously. They should be updated from month to month at the line item level and be monitored continuously by the Budget Preparation Sector of the Ministry of Finance.

For the sake of budgetary discipline it is important to make a clear distinction between the multi-annual expenditure totals of first-level budget users (ministries and independent public law agencies) and line item estimates. The latter should be flexible in order to accommodate unexpected developments, including overspending on entitlements, and new spending priorities. The former should be as inflexible as possible. The enforcement of the totals is a crucial task of the minister of finance and the prime minister. In this respect further progress should be made in the coming years.

It is important that the budget documents explain carefully from year to year how the budgetary and multi-annual line item estimates relate to the multi-annual estimates of the previous year. Presently this information is largely lacking which makes it difficult for Parliament and civil society to assess the budget proposals of the government.

As in many OECD countries, Parliament approves the budget on a cash basis but in the explanatory documents the government presents a consolidated central government balance and a consolidated general government balance on a commitment basis. However in the budget documents, as opposed to the retrospective financial reports, there is not yet a fully transparent explanation of how the balance on a commitment basis is related to the cash balance nor how the consolidated general government balance is related to the consolidated central government balance. In the absence of such information it is difficult for Parliament to assess the general budgetary strategy in the context of the medium-term fiscal framework.

In Croatia no attempt has yet been made to estimate tax expenditures. Reporting on tax expenditures is important in order to facilitate a more rational use of this instrument and to allow trade-offs with other expenditures.

### 3. Parliamentary approval

#### Box 3. The Croatian Parliament (Sabor)

A multi-party Parliament (Hrvatski Sabor) was constituted after the democratic elections in May 1990. Croatia initially had a bicameral Parliament consisting of the Chamber of Deputies with legislative authority, and the Chamber of Counties with an advisory role and the right to lodge so-called suspension vetoes. The constitutional amendments of 2000 abolished the Chamber of Counties and transformed the semi-presidential system into a parliamentary system of government. According to the Constitution, the Croatian Parliament is to have a minimum of 100 and a maximum of 160 members. The electoral system is based on proportional representation. Members are elected from party lists by popular vote to serve four-year terms. Croatians residing abroad and the autochthonous national minorities have special constituencies that ensure their representation.

Sources: Inter-Parliamentary Union ([www.ipu.org](http://www.ipu.org)); Croatian Parliament.

#### 3.1. Legal framework

The Constitution, the Budget Act of 2003 (the organic budget law), and the parliamentary Standing Orders legally define the budgetary role of the Croatian Parliament. The Constitution obliges the government to propose a state budget (Article 112), which has to be approved by Parliament in order to become effective (Article 80). Failure to adopt the budget within 120 days from the date when it was proposed can result in the dissolution of Parliament (Article 103). This has not happened since the Constitution was adopted in 1990.

The powers of Parliament to amend the budget are circumscribed by the Budget Act (Article 31), according to which any amendments and supplements to the proposed budget may not alter the deficit. During the parliamentary debate on the budget proposal, an amendment proposing an increase in expenditure may only be accepted if it is financed by a commensurate cut of another item of expenditure, but not from budgetary reserves or additional borrowing. Similar constraints on parliamentary amendments exist in several other countries in the region, for example Romania (Ruffner *et al.*, 2005) and Slovenia (Kraan and Wehner, 2005).

The Budget Act also regulates the broad time parameters for the parliamentary process. The government has to table the budget proposal for the coming year by 15 November of the current year (Article 30). Parliament in turn is to enact the budget before the beginning of the fiscal

year to which it relates (Article 32). If the budget is not approved in time, Parliament has to make a decision on provisional financing (Article 35). This is limited to a period of up to three months and a maximum of one-quarter of realised total income during the previous fiscal year. During a period of provisional financing, no new programmes may be created and budget users may not increase their number of staff or assume any new financial obligations. There have been six provisional budgets since 1990, due to delays in preparing the draft budget.

While the Budget Act sets out the main steps of budget formulation within the executive branch, it does not prescribe an opportunity for Parliament to discuss the budget strategy before the budget guidelines are adopted. To encourage debate on budget aggregates, the *OECD Best Practices for Budget Transparency* recommend the publication of a pre-budget report (OECD, 2002a). Early parliamentary deliberation on the budget totals may provide greater guidance for the legislative phase of the budget process. On the other hand it may be argued that in the Croatian case there is less reason for such a process than in some other countries, because of the constitutional limitation that Parliament cannot alter the budget in a way that would increase the deficit.

### ***3.2. The Finance and Central Budget Committee***

The parliamentary Standing Orders provide for the establishment of the Finance and Central Budget Committee as a working body of Parliament (Article 56) and give the committee a range of responsibilities (Article 65). These include the public finance system, the central government budget and accounts, audit reports, the tax system and tax policy, as well as various other duties relating for instance to the banking sector, foreign transactions, and the monetary system. An amendment to the Standing Orders in 2002 further extended the areas of responsibility of the committee to the structure, authority and operating methods of the State Audit Office (SAO) and the Financial Agency (FINA). The committee's jurisdiction is thus very comprehensive and encompasses all aspects of public financial decision making. On the other hand, such a broad mandate also constrains the amount of time that the committee can devote to any one of its particular responsibilities.

The composition of the committee reflects corporatist ideas and is unusual compared with OECD member countries. The Standing Orders prescribe that the Finance and Central Budget Committee has a chairperson, a deputy chairperson and 11 members who are parliamentarians (Article 66). Six additional members are also appointed: one each from among higher-level trade union representatives, the employers' association and the

Croatian Chamber of Commerce, and three representatives of scientific and professional institutions. While these six additional members may attend committee meetings, they have no voting rights. The provisions for other parliamentary committees are similar. For example, the Judiciary Committee has six additional members who are appointed from among public officials, scholars and relevant professionals. These arrangements give interest groups a formal consultative role in the decision-making process.

A secretary supports the Finance and Central Budget Committee and the committee may also employ consultants. Given the extensive areas of responsibility of the committee, this limited access to supporting staff does not allow for detailed budgetary analysis in aid of parliamentary scrutiny. Members of Parliament also have access to the services of a parliamentary library and a small information and documentation unit, but neither of these have analytical capacity. The formation of legislative expertise is also hampered by membership turnover. Moreover, the Croatian Parliament has 24 committees, and parliamentarians may serve on more than one committee simultaneously. As a result, ensuring attendance can be problematic. These factors impede the effectiveness of the Finance and Central Budget Committee (Bratić, 2004, p. 16).

### ***3.3. Parliamentary process***

As noted above, the Budget Act prescribes the tabling of the budget by mid-November, one and a half months before the beginning of the fiscal year. Compared with international standards and practices, the timing of the parliamentary budget process in Croatia is very tight. A recent survey of OECD and non-OECD countries shows that in more than two-thirds of the 41 countries surveyed the legislature receives the budget at least two months or more prior to the beginning of the fiscal year (OECD and World Bank, 2003, question 2.7.b). The OECD recommends a minimum of three months prior to the beginning of the fiscal year for the tabling of the budget in the legislature (OECD, 2002a).

The central government budget and the financial plans of extra-budgetary users are submitted to the president of Parliament, together with the budget execution bill. The president of Parliament then refers the draft budget for comment to the Finance and Central Budget Committee as well as other working bodies for consideration. Debate in the committees serves the formulation of amendment proposals that are contained in reports submitted to the president. Individual Members of Parliament, committees, party groups, and the government may propose amendments.

The plenary session considers the budget by sections and by amendments. The debate in the plenary appears to have an important

publicity function for individual parliamentarians, but its impact on budget policy is extremely limited. These debates attract attention in the press and are broadcast on television. Members of Parliament sometimes propose hundreds of amendments, but the Finance and Central Budget Committee views many of them as “unrealistic”. The Standing Orders prescribe that a vote on the submitted amendments and the budget as a whole may not be held prior to the expiry of three days after the debate (Article 175). This gives the government a chance to respond to the proposed amendments. Although a large number of amendment proposals are generated, very few of them are actually adopted. The Finance and Central Budget Committee reports that during the debate on the 2005 budget, 400 amendments were proposed. Out of this total, only nine were ultimately adopted.

During the course of the financial year, Parliament also receives information on the execution of the central government budget. The Budget Act requires the government to prepare a semi-annual statement on budget execution and to submit it to Parliament no later than 5 August of the current budget year (Article 125). The Finance and Central Budget Committee does not view reallocations and revisions during budget execution as an issue of concern, which suggests that the monitoring of budget implementation by Parliament is not strongly developed. Moreover, in the absence of adequately trained support staff, in-depth monitoring of budget execution would most likely overburden the Finance and Central Budget Committee. In addition to limited in-year monitoring, Parliament also considers the execution of the budget following the end of the fiscal year. This aspect is considered separately in section 5 below, on audit and accountability.

### ***3.4. Conclusion***

The Croatian Parliament plays a minor role in the formulation of budget policy. The timing of the budget process is very constrained compared with international practice, and this gives parliamentarians little chance for detailed engagement and analysis of the budget. The curtailment of parliamentary amendment powers helps to ensure that amendments are not detrimental to fiscal discipline, which can be seen as an important safeguard, but in any case very few amendments are actually passed.

To strengthen parliamentary scrutiny, some of the following options might be considered:

- An increase in resources available to the Finance and Central Budget Committee would allow it to maintain an appropriate number of analytical staff in support of its budgetary functions. Such support is particularly important when parliamentarians have

overlapping committee assignments and hence limited time to scrutinise budgetary details.

- A working group of parliamentarians and Ministry of Finance officials could be established in order to review the usefulness of budget documentation, and to form a common understanding of the desirable level of detail contained therein. A reduction of items in the budget is a necessary step in order to strengthen the performance orientation of the budget process. Ultimately, parliamentarians would benefit from increased accountability for results, even if they have to forfeit micromanagement of small items.
- Currently, Parliament appears to pay very limited attention to implementation issues, which is a gap in oversight. The credibility of the budget could be enhanced if there were an increased focus on deviations from budgeted amounts during the fiscal year.

## 4. Budget execution

### *4.1. The organisation of budget execution*

The basic principles of budget execution are laid down in the Budget Act and the annual Law on Budget Execution.<sup>11</sup> The Law on Budget Execution is passed at the same time as the budget, and many rules regarding budget execution are found in this law and not in the Budget Act.

During the budget year, the Budget Execution Department of the Budget Execution Sector approves budget users' expenditures and orders payments from the Treasury Single Account (TSA), while the Budget Preparation Sector monitors actual development of budget users' expenditures (see Figure 4 above).

The Budget Execution Sector is the main body responsible for budget execution. It consists of a Department for Domestic Currency Payments; a Department for Foreign Currency Payments, a State Accounting Department and a Cash Management Department (see Figure 4). The Department for Domestic Currency Payments consists of the Unit for Domestic Currency Payment and the Unit for Legal/Financial Affairs. The State Accounting Department is responsible for the Treasury ledger, determining accounting standards and recording of transactions. The Cash Management Department is responsible for establishing a cash flow plan in order to make sure that short-term borrowing and investments of cash deficits/surpluses are managed effectively and efficiently.

The Department for Domestic Currency Payments has a staff of 13 and is mainly in contact with the 51 first-level budget users. Generally, there is more contact between the Department for Domestic Currency Payments and a large budget user than a small one. Examples of large budget users are the Health Insurance Fund and the Pension Fund.

The main information system for the Ministry of Finance is an SAP<sup>12</sup> government financial management system that is used for budget preparation, state accounting, budget execution and management of funds. Budget users have their own accounting systems. Only first and second-level budget users have direct access to SAP. Transactions and other information for third-level budget users have to be forwarded to first or second-level budget users to be compiled and entered into SAP. According to the Ministry of Finance, the system has certain drawbacks that are presently being addressed. One example is that the SAP system is not yet entirely integrated with other systems that are used by the Ministry of Finance and budget users. Information from budget users' accounting systems cannot automatically be transferred to SAP; instead transactions have to be manually entered into several systems. Also the system is not fully compatible with the needs for good cash management, as obligations and liabilities can only be entered in the month that payments have to be made. Furthermore, several other systems, for example the ones used by the Public Debt Management Sector, are not compatible with SAP. The SAP system is under development in order to improve these aspects.

Included in the Croatian budget is a reserve that the government can use for unforeseen expenditures. The size of the budgetary reserve is determined by the budget and, according to Article 45 of the Budget Act, cannot exceed 0.5% of budget revenues (including taxes but excluding receipts such as user charges and fees). Although the government can use the reserve discretionally, it has to report use of the reserve to the Sabor (the Croatian Parliament).

#### ***4.2. Cash and debt management***

For effective and efficient implementation of the budget, the central government must make sure that cash and liquidity are managed so that liabilities can be met, revenues are collected in a timely manner, and cash balances do not stand idle.

Cash management is the responsibility of the Cash Management Department of the Budget Execution Sector. Several reforms have improved the Treasury's ability to manage cash and liquidity in recent years (see Figure 4). The most important steps have been the creation of a Treasury Single Account (TSA) for the national currency (kuna) in 2001 in the

Croatian National Bank<sup>13</sup> and the recent inclusion of some extra-budgetary funds into the TSA. With the inclusion of most extra-budgetary funds, around 95% of the central government payments now go through the TSA. Budget users are allowed (often compelled) to have an account in the Postanski Bank (state-owned bank) for transaction purposes. At present there are 292 budget user accounts in the postal bank. Budget users can hold a balance on these accounts, but the balance is monitored by the Ministry of Finance and the balance can at any moment be withdrawn from the accounts to the TSA if deemed necessary. The situation is a bit different for accounts in foreign currency: although a TSA for foreign currency exists, budget users still have foreign currency accounts in private banks.

#### **Box 4. Systems of cash management**

There are basically three models of cash management in central governments.

In the decentralised model (in place in Croatia before the introduction of the Treasury Single Account), all budget users have their own account with the commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budget users make payment orders by drawing on their own accounts.

In the centralised model (now mainly in place in Croatia) budget users are not allowed to have their own accounts with the commercial banks. There is only a single account (with sub-accounts) usually kept at the Croatian National Bank, which is under the Treasury. Since the Treasury is not allowed to borrow from the Croatian National Bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budget users have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget users are allowed to have their own bank accounts with a single commercial bank, but the positive balances on these accounts are daily transferred to the Treasury account with the central bank and daily supplied with cash advances. The contract with the commercial bank is auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget users make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term borrowing at the Treasury.

**Table 5. Reforms of the Croatian cash management system 2001-03**

Change	Year	Objective
Reform of the kuna payment system.	2001	Execution of payment clearing in the banks.
Ban on government borrowing in the Croatian National Bank.	2001	Financing from primary emission made impossible.
Control of national budget liabilities.	2001	Improvement of fiscal discipline and orderly execution of the budget.
TSA – kuna.	2001	Centralisation of budget cash flows and deposits at the Treasury and the Croatian National Bank.
TSA – foreign currency.	2003	Centralisation of foreign currency deposits of the government at the Treasury.
Improvement of foreign currency payments clearing in government accounts.	2003	Improvement of foreign currency payments clearing in the Croatian National Bank.

Source: Bajo (2005).

The budget execution process starts when the Sabor approves the budget for the next fiscal year. After approval, the Budget preparation sector defines allocations for all three levels of budget users on an annual basis, in accordance with amounts decided in the budget (Table 6). In the next step, first and second-level budget users divide the allocations over the twelve months of the budget year and submit an annual cash plan divided by month on the basis of estimation of payment due date. The annual cash plans are entered in the SAP system by the relevant local treasury (the treasuries of the first and second-level budget users are commonly called local treasuries).

The cash plans are reviewed and approved by the Budget Preparation Sector and delivered to the Budget Execution Sector where maximum cash amounts are allocated. Budget user's local treasuries enter their cash plans in SAP, if necessary after revision, in accordance with the allocated maximum cash amounts. Local treasuries update and adjust the cash plans of budget users during the budget year. The monthly plans are approved each time by the Budget Preparation Sector.

During the budget year the Cash Management Department makes monthly allotments to make sure that expenditures are within limits of available cash resources. Budget users enter payment requests in SAP and the Department for Domestic Currency Payments pays invoices according to their maturity date and salaries when they are due. Actual collection of

revenues and payment of expenditures are handled by the Financial Agency (FINA).

**Table 6. Stages of the budget execution process**

Action	Responsible for entering the information in the SAP system
1. Allocation of funds to all levels of budget users	Budget Preparation Sector
2. Annual cash plans, divided by month	Local treasury
3. Allocation of maximum cash amounts	Department for Domestic Currency Payments
4. Revised cash plans	Local treasury
5. Monthly allotments	Cash Management Department
6. Reservations	Local treasury
7. Payment requests	Local treasury
8. Payments	Department for Domestic Currency Payments

Invoices or payment requests are sent to local treasuries from suppliers or from the lower level of budget users (see Figure 5). Information on wages for government staff is taken directly from staff data. Local treasuries collect the information and send bulk payment requests to the Central Government Treasury (Budget Execution Sector) and to FINA. When the Budget Execution Sector accepts the payments, it orders FINA to make the actual payments. The cash is transferred by FINA from the TSA either directly to suppliers (or employees' bank accounts) through TSA sub-accounts, or via budget users' transaction accounts in the Croatian Postansk Bank.

Cash flow projections are made on a monthly, weekly and daily basis. The revenue and cash position is the sum of daily balances in kuna and foreign currencies (in the TSA, the Croatian Postansk Bank and commercial banks). Cash flow projections are based on the most actual cash plans of budget users, the revenue forecast from the Macroeconomic Analysis and Forecast Bureau of the Ministry of Finance, and cash plans for interest, repayments of public debt and payments on guaranteed debt default from the Public Debt Management Sector.

For efficient cash management it is important that liabilities are entered into SAP as soon as possible, but at present the system still has weaknesses in this respect. Since SAP is ill-suited to handle obligations that are due in future months, the present SAP system only works as a cash transaction system, not a tool for cash management. An assistance project funded by the

EU is being introduced with the aim of linking budget users' accounting systems with SAP and making it possible to enter obligations when incurred into the SAP system.

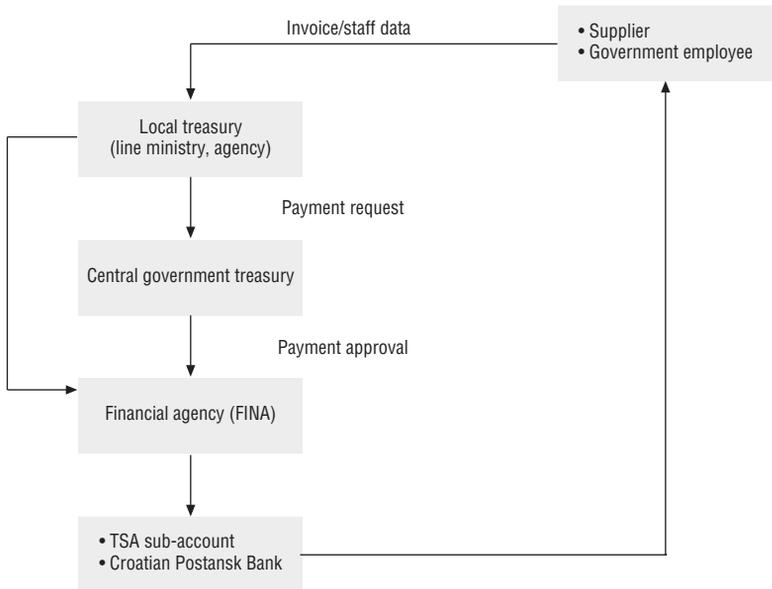
### **Box 5. The Financial Agency (FINA)**

A rather unique feature of the Croatian financial management system is the Financial Agency, which is a heritage from the former Yugoslavia where the Social Accounting Service was the institution responsible for execution of all public transactions. In 1993 this institution was renamed the Institute for Payment Transactions (ZAP) and in 2001 reformed and renamed FINA.

FINA has a central role in the Croatian financial system, including the large public enterprise sector, and presently also for the private sector. It is formally a central government agency; its board is appointed by the government and is financed by fees that the government pays for services that it provides. FINA handles a wide range of functions for the government. All government transactions to and from the TSA go through FINA, both on the revenue and on the expenditure side. Taxes are collected by FINA and, depending on tax shares, transferred to different levels of government. On the expenditure side, payment orders are sent to FINA which then executes, upon approval from the Budget Execution Sector, the actual payments from the TSA to receivers. The same applies to wages for government employees and other transfers. Payment orders are sent to FINA which then draws money from the TSA to pay recipients. FINA records a detailed set of data on revenues and expenditures and reports to the Ministry of Finance through the SAP information system. The information is generally seen as reliable and of high quality.

Presently, FINA also plays an important role in the private sector. Around 80% of its revenues come from services that it performs for the private sector (primarily banks). It has around 180 branches and acts as a bank, a postal transfer system, and a clearing house for banks.

There have been discussions about incorporating at least the part of FINA that operates on behalf of the government into the Ministry of Finance, but nothing has been done so far. In Slovenia, a similar institution existed that has partially been included in the Ministry of Finance and partially contracted out to the commercial banking sector. An important reason that complicates the merger of FINA into the Ministry of Finance is that wages are much higher in FINA compared to the Ministry of Finance. Also, the fact that the system is working quite well has contributed to the hands-off policy.

**Figure 5. From invoice to payment**

Cash management with detailed preventive control by the Ministry of Finance is a practice that many OECD countries have abandoned. In fact the Budget Execution Sector exerts a double control, first through the allocation of annual maximum cash amounts, and second through the allotment of monthly cash ceilings. The need for preventive cash control is a consequence of the lack of budgetary discipline. If the budget cannot be relied on as a mechanism of control because of insufficient monitoring and updating, control is relocated to the cash management process. The first priority for the reform of the budget process is therefore the strengthening of budgetary discipline. For that purpose it is necessary that the budget itself, including the multi-year estimates, rather than the annual cash plan is continually updated during budget execution<sup>14</sup> and that the Budget Preparation Sector takes a more active monitoring role during the execution stage. The monitoring and updating of the budget and the multi-year estimates not only takes account of the accuracy of the estimates in the light of the progressing spending process (payments and obligations incurred) but have a much wider scope. In particular the process of monitoring and updating takes care of new spending priorities and planned reallocations including their multi-annual consequences.

The updating of the budget ought to become a monthly subject of discussion between the Budget Preparation Department and the local treasuries. Unreliable updating ought to be signalled to the minister of finance and overspending ought to be sanctioned by the government. Presently the Budget Preparation Sector with a staff of 12 (apart from the Department for Local Governments) is clearly not capable of handling this task. To the extent that the budget itself becomes a reliable tool of control during budget execution, the preventive controls by the Budget Execution Sector can be reduced and eventually abolished.

Debt management is the responsibility of the Public Debt Management Sector. Different departments within the Public Debt Management Sector are involved in all areas of short and long-term debt management including drafting debt strategy on a three-year horizon, risk management, analysing the debt portfolio and keeping accounts of debt. Several departments that are supposed to be operational are not functional today. Instead their tasks are handled by other departments.

Within the Public Debt Management Sector there is also a department responsible for state guarantees. This department keeps a record of central government guarantees, evaluates state guarantees, and evaluates requests for new state guarantees.<sup>15</sup> As is the case for the departments responsible for central government debt, this department is not at present fully staffed.

There is a lack of transparency with respect to the use of guarantees. According to the IMF, guarantees are systematically used to circumvent budgetary discipline (IMF, 2004b). The annual Law on Budget Execution sets a ceiling on the value of new guarantees the central government may issue in the budget year. Each guarantee must be approved by the minister of finance on the basis of criteria set out in the Law on Budget Execution. The annual budget contains a line item to meet the estimated cash costs of making payments under called guarantees. It is not clear how this line item has been estimated. There is no information in the budget documents about risk analysis of total outstanding guarantees nor on past calls (IMF, 2004b). Moreover, there is no clear policy regarding the use of guarantees as an alternative to direct expenditures or state loans in the light of default risk and interest costs.

The data system of the Public Debt Management Sector is not interfaced with SAP, reducing the scope for using the SAP system as an overall financial management tool.

### ***4.3. Service delivery***

The state administration consists of the central bodies of state administration and the decentralised offices of state administration. The central bodies of state administration are the ministries, central administrative offices, and administrative organisations (independent public law agencies). There are 13 ministries, four central administrative offices, and eight administrative organisations (OECD, 2004). The decentralised offices of state organisation organise and oversee central government duties in the counties. There are 20 offices of this type, one in each of the counties. Apart from the central government, there are 570 sub-national units, namely 20 counties, 123 cities, 426 municipalities, and the capital Zagreb. Due to recent decentralisation, the areas of responsibility for the sub-national governments have increased significantly.

OECD countries that have traditionally separated the policy development and policy execution organisations (the Nordic countries) or that in recent years have moved in that direction (the Netherlands, the United Kingdom) have generally attempted to realise two benefits from this split:

- More freedom for executive agencies concerning the production process and the input mix in order to enhance efficiency;
- Better information about cost prices of outputs.

Both benefits are dependent on accurate output information and a close monitoring of outputs by the central ministries. Both benefits are not fully realised in the Croatian central and decentralised agencies. First, budgets of agencies generally remain largely on a detailed input basis which impedes the autonomy of agencies concerning the production process and the input mix. Second, outputs are not well defined, and monitoring procedures on outputs in the central ministries are feeble. Under these conditions the separation can even have adverse effects. Insofar as agencies have more autonomy than ministerial line offices, they can use that autonomy to hide their resources from oversight. This risk is especially acute in independent public law agencies which may even enjoy legal protection. It is therefore important that Croatia takes further steps to define outputs and improve and institutionalise its oversight procedures for central and decentralised agencies. In a next stage agencies could be given more autonomy, and more executive branches could be split off from the central ministries.

Croatia has recently modernised its procurement procedures in accordance with EU legislation and has started the implementation of those procedures.

### Box 6. Procurement

In Croatia the procedure for publishing tenders for public procurement was promoted to a legislative norm in 1997 with the Law on Procurement of Goods, Services and Works (Official Gazette No. 142/97). This law was replaced in 2001 by the Public Procurement Act (Official Gazette No. 117/01) which aimed at harmonisation with EU procurement legislation and introduced the Public Procurement Office within the Ministry of Finance as an advisory body for procurement. The State Commission for Supervision of Public Procurement Procedures (set up in late 2003) handles complaints regarding procurement. Appeals can be submitted for tenders under these procurement procedures. The State Commission is a specialised instance of semi-judicial type, independent and only responsible to the Sabor (Parliament). Decisions of the State Commission are final. The procurement law applies to all levels of government.

The threshold for procurement is HRK 200 000 (before tax). (The exchange rate of the kuna is around EUR 0.138.) According to the law, tenders between HRK 6 000 000 and HRK 12 000 000 must be subject to international competition.

Introducing this legislation was a significant change, and it altered contract practices between the public and the private sector in Croatia. It has been an important step towards improving the way public funds are being used and has improved trust in government and decreased corruption.

At the moment, the Croatian authorities are revising the procurement law to bring it in line with recent development in EU legislation.

Due to recent decentralisation, the sub-national part of the general government has increased, but the central government still accounts for more than 80% of the general government expenditures. The distribution of functions between the central and sub-national parts of government is complex. Decentralisation of functions has not been the same in all parts of Croatia and has started with sub-national units that have been judged fit to take over the provision of services from the central government.

Reform of the administration is an important part of the Croatian efforts towards integration with the EU. Several recent laws aim at the strengthening of the central government's capacity to manage and control the public sector<sup>16</sup> and other initiatives are in the pipeline. This work includes modernisation of legislation regarding the civil service, improving the organisational structure of the government, a clearer separation of the permanent civil service and political appointments, and improving the educational facilities for the civil service.

#### ***4.4. Conclusion***

The Croatian cash management system is characterised by heavy preventive control by the Ministry of Finance. The need for preventive cash control is a consequence of the lack of budgetary discipline during budget execution. If the budget cannot be relied on as a mechanism of control, control is relocated to the cash management process. The first priority for the reform of the budget execution process is therefore the strengthening of budgetary discipline. For that purpose it is necessary that the budget itself, including the multi-year estimates, is continually updated and monitored during budget execution and that the Budget Preparation Sector takes a more active role during the execution stage. To the extent that the budget itself becomes a reliable tool of control during budget execution, the preventive controls by the Budget Execution Department and the Cash Management Department can be reduced and eventually abolished.

The Budget Preparation Sector, with a staff of 12 (apart from the Department for Local Governments), is clearly understaffed and needs to be expanded to enhance the budget as the primary instrument of budgetary control.

At present, debt management is not up to date, mainly because of lack of staff and problems relating to merging information systems. Also, a clear policy regarding guarantees should be developed to reduce the fiscal risk for the government. Improving the information systems and giving the Public Debt Management Sector the full responsibility for all central government debt would improve the possibilities for an effective management of debt.

The benefits of separation of policy implementation and execution are not fully realised in the Croatian central and decentralised agencies. It is important that Croatia takes further steps to define outputs and improve and institutionalise its oversight procedures on central and decentralised agencies. In a next stage agencies could be given more autonomy, and more executive branches could be split off from the central ministries.

Croatia has taken important steps to bring its procurement procedures into accordance with EU legislation and has started the implementation of those procedures.

### **5. Audit and accountability**

#### ***5.1. End-of-year reporting***

Croatia used cash-based accounting until 2001, but in 2002 moved to a modified accrual basis (the budget remains on a cash basis). For the

modified accrual accounts, expenses are registered at the time a commitment is made and revenue records are based on financial income in the reporting period. The Budget Act of 2003 (Article 121) and the Decree on Budget Accounting require the end-of-year financial statements to be presented on a modified accrual basis. The long-term objective of the government is to move to full accrual accounting. Ministry of Finance officials note that the move to modified accruals has brought benefits, in particular an improvement in the control of arrears accumulated by budget users. But the transition has not been without difficulties, partly due to a lack of prerequisite accounting skills amongst some budget users. Moreover, the accounting system is fragmented. Budget users frequently operate different systems for different types of expenditures, which makes the preparation of financial statements cumbersome and vulnerable to errors. The State Audit Office (SAO) notes that the number of errors in the submitted accounts has decreased over the past three years, although it still picks up and reports individual cases where expenses are recorded on a cash basis.

The accounting reform also brought forward the date for the submission of accounts by one month. Financial statements for a budget year are now to be submitted to the Ministry of Finance and the SAO by 31 January of the current year for the previous year. Meeting this new deadline proved difficult for some budget users, and there have been several requests for extension of the deadline. This included a number of high-spending budget users, such as the Ministry of Finance, the Ministry of Agriculture, Forestry and Water Management, the Croatian Institute for Pension Insurance, and the Ministry of Science, Education and Sports. The SAO has warned that the deadline is too tight and has recommended an extension. Although the Ministry of Finance itself has encountered difficulties in meeting the deadline, the latter has so far not been revised.

End-of-year budget reporting to Parliament remains mainly on a cash basis. The Budget Act does not clearly distinguish between the different end-of-year reports. The act outlines the process for the compilation of a report on budget execution, which is referred to as the “annual statement of budget accounts” (Articles 124-128). Budget users under a ministry have until the end of February following the end of the fiscal year to submit budget accounts to the relevant line ministry. Each line ministry is then charged with reviewing, harmonising, and consolidating these data and submitting them to the Ministry of Finance by the end of March. The Ministry of Finance, in turn, is charged with preparing the consolidated statement of budget accounts and submitting it to the government by the beginning of May. The annual statement of budget accounts has to be transmitted to the SAO as well as to Parliament for approval by June, but there have been difficulties in meeting the deadline.

End-of-year reporting on quasi-fiscal activities is not comprehensive. Although quasi-fiscal activities are not part of the budget process, since 2003 efforts have been made to provide more information on these types of expenditures in end-of-year reports. For 2003 an expenditure total of HRK 2.5 billion (1.3% of GDP) was reported on a selection of quasi-fiscal expenditures consisting mainly of guarantees provided to Croatian Motorways, Croatian Roads and HBOR, equity acquisition by the Croatian Privatisation Fund and cumulative changes in arrears (Government of the Republic of Croatia, 2004c). Quasi-fiscal expenditures of HBOR were reported to amount to 0.4% of GDP in 2004, and were projected to remain at this level in 2005 (IMF, 2005). Until now, quasi-fiscal activities other than HBOR operations and arrears are not systematically reflected in end-of-year reports.

## **5.2. External audit**

The SAO is Croatia's supreme audit institution and was founded in 1993. The fundamental legal framework for the operation of the SAO is the State Audit Act. The act establishes the SAO as "directly responsible" to Parliament (Article 10). The office is headed by the Auditor General who is appointed by Parliament for a renewable term of eight years.<sup>17</sup> The SAO has to carry out annual financial audits of the state budget, extra-budgetary funds at the national level, and budgets of local and regional self-government units. Audits of the financial statements of central government, local and regional government units, public enterprises, and companies with government majority shareholdings are performed in accordance with an annual programme.

The SAO has about 270 employees, of which 230 are certified state auditors and most have backgrounds in economics or law. The SAO has a central office, in the capital Zagreb, which is structured into several departments with responsibility for development and methods, legal affairs, human resources, European Union funds, the state budget, local government budgets, and state-owned enterprises. This is complemented with a network of 20 regional branches that are under the control of the central office. The SAO is funded from the state budget, and its allocation is approved as part of the regular budget process.

The State Audit Act (Article 3) prescribes that the SAO's annual audit programme has to be passed by Parliament. It is unusual for a legislature to have such strong formal powers over the planned audit activities of the supreme audit institution. In member countries of the OECD, the dominant practice is that audit institutions have statutory independence in determining their audit programme, although they may consult with relevant legislative

committees (United Kingdom National Audit Office, 2001; OECD, 2002b). The International Organisation of Supreme Audit Institutions (INTOSAI) explicitly highlights the need for autonomy in the determination of the audit programme.<sup>18</sup> Substantive interference may lead to the politicisation of the work of a supreme auditor and undermine her/his impartiality. In practice, it appears that the Croatian Parliament does not exercise its formal powers to influence the annual audit programme of the SAO, but such a convention offers less protection against parliamentary interference than statutory safeguards.<sup>19</sup>

The definition of audit in the State Audit Act is broad and covers financial as well as performance audit (Article 2). Until the end of 2004, a substantial part of audit capacity was absorbed by audits of privatisation activities in the 1990s.<sup>20</sup> With this work concluded, more time and resources can be directed towards regular annual audit activities. The development of capacity for performance audit is very recent, and is taken forward in a twinning project with the National Audit Office (NAO) of the United Kingdom. At present, 26 SAO staff members receive training in performance auditing as part of the twinning project. Relevant manuals from the NAO and INTOSAI have been translated to prepare for the execution of performance audits. No substantial performance audit work has been carried out to date, but four such audits are planned for next year. These include the audit of a national park that will be carried out in co-operation with the Court of Audit of the Republic of Slovenia.

The SAO estimates that it produces about 600 reports per year, which are summarised in its annual report. The State Audit Act requires the SAO to submit an annual report on executed audits and its own work to Parliament no later than five months following the expiry of the date for submission of annual financial statements (Article 11). In practice, there have been delays, in particular following the accounting reform in 2002, when many budget users struggled to ensure the timely submission of accounts. As a result, the annual report of the SAO on the 2002 accounts was presented more than 12 months after the end of that fiscal year. The next annual report was more timely (see Table 7).

### ***5.3. Parliamentary audit***

Following the finalisation of an annual report of the SAO, the Auditor General presents a summary of audit findings to the plenary, and Parliament has an opportunity to question the Auditor General. The Croatian Parliament does not have a specialised audit committee. The Finance and Central Budget Committee is a main recipient of audit reports, as well as the

Domestic Policy and National Security Committee. Other committees may consider relevant findings as appropriate.

**Table 7. The timeliness of audit reporting 1994-2003**

Audit report for fiscal year	Date submitted to Parliament
1994	13 December 1995
1995	11 November 1996
1996	4 November 1997
1997	9 November 1998
1998	9 November 1999
1999	11 November 2000
2000	24 October 2001
2001	23 October 2002
2002	16 January 2004
2003	29 October 2004

Source: State Audit Office.

The Finance and Central Budget Committee noted that audit scrutiny takes up less of its time compared with the discussion of the draft budget. Of the several hundred individual audit reports that are generated each year, most relate to the local government level, and very few of these reports are reviewed in depth. Although the Auditor General and representatives from the audited government bodies are invited to relevant committee sessions, the detailed interrogation of witnesses with regard to individual audits is rare. Typically, audit reports are discussed in conjunction with other items on a committee's agenda.

Parliament considers the government's annual statement on the execution of the budget, following a process that is formally similar to its approval of the draft budget. Parliament approves a report on budget execution containing conclusions that may be used to direct government to take action on certain issues. The effectiveness of this mechanism is unclear. Parliament has never refused approval of budget execution, and there is no regular follow-up mechanism to check whether any issues raised by Parliament were actually addressed by the government. Also, this process is not integrated with a review of audit findings by the Auditor General.

#### ***5.4. Development of internal audit***

Croatia is in the process of establishing capacity for internal audit. The Budget Act provides a legal basis for internal audit of budget users, which is also a requirement for accession to the European Union.<sup>21</sup> According to the act, internal audit units are to establish “independently and objectively” whether budget users accomplish their functions, point out instances of irregularities or non-compliance with legal provisions, and propose remedial actions (Article 137). The specific responsibilities of the internal auditor include assessing the quality of internal control and accounting, and examining transactions (Article 138). She/he is to present a written report to the head of the government unit (budget user) at least semi-annually, as well as a separate report on any irregularities that are uncovered. A rulebook and a manual for internal audit have been developed, and the government adopted a development strategy for public internal financial control, including internal audit, in May 2005.<sup>22</sup>

Since internal audit is a recently introduced concept, these arrangements are not yet operational, but line ministries have embarked on the process of creating internal audit capacity. One of the largest budget users reported that an internal audit unit had been set up that consists of five people. This is one of the biggest internal audit units among the different spending ministries. Staff members of this unit were receiving appropriate training, but no actual audit activities had been carried out up to that date. At the time of this review, central government had a total of 12 certified internal auditors and 55 candidates who were in the process of completing the qualification. Therefore, it is still too early to draw any conclusions about the effectiveness of these new structures.

#### ***5.5. Conclusion***

Croatia’s audit and accountability arrangements have undergone significant change over recent years. These include efforts to move to accrual accounting and to achieve timely production of financial statements, the building of capacity for performance audit in the SAO, and the institutionalisation of an internal audit function. These developments are positive, but will take time to become established.

It is important to remain realistic about the pace of reform, and to allow for and proactively manage initial teething problems. The following issues deserve further consideration:

- The timeliness of accounting and audit could be improved. The deadline for the submission of financial statements to the SAO may be overly ambitious, in particular in the context of recent accounting

reforms. An extension of the deadline, as suggested by the SAO, appears reasonable and may make the process more realistic and credible. However, it should be a medium-term goal to bring the delivery of audit reporting forward.

- End-of-year reporting is currently disjointed. While Parliament considers the statement on budget execution, this process appears to be largely formalistic and is not firmly linked to a discussion of audit findings relating to the financial statements. These two processes should be integrated, as audit findings can significantly contribute to understanding problematic issues in budget implementation.
- The SAO has insufficient statutory independence in deciding its annual audit programme. The requirement for parliamentary approval of the audit programme should be removed, or at a minimum substituted with a requirement for a non-binding consultation. While the current provision may not so far have been problematic in practice, it is out of line with international standards. It is crucial for the credibility of external audit that the statutory framework safeguards against eventualities where political interference may be attempted.
- It appears desirable to strengthen Parliament's institutional capacity for ex post oversight. Given the fact that a relatively modest number of parliamentarians already have to serve on a large number of committees, the creation of a separate Public Accounts Committee may not be a viable solution. As a compromise, Parliament may consider setting up a sub-committee on audit under the Finance and Central Budget Committee and recruiting support staff to monitor audit reporting.

## **6. Financial relations between levels of government**

### ***6.1. Decentralisation***

In Croatia, the sub-national government level is divided into two parts, regions (counties) and local government (cities and municipalities). There are 570 sub-national units divided into 20 counties, 123 cities, 426 municipalities, and the capital Zagreb. Zagreb has a special status and is considered both a county and a city (not included in the previous figures and usually counted as the 21<sup>st</sup> county). The size of sub-national units varies considerably. Zagreb is the most populous county and at the same time geographically the smallest (779 000 inhabitants, 641 km<sup>2</sup>). The least

inhabited county is Ličko-senjska with 54 000 inhabitants covering an area of more than 5 000 km<sup>2</sup>.

Croatia is a unitary state and sub-national responsibilities are defined by law, not in the Constitution. Counties are responsible for activities of regional importance, such as education, health care, urban planning, economic development, traffic and transport infrastructure, and establishing a network of educational, health, social and cultural institutions. Cities and municipalities are responsible for local activities whose purpose is to accommodate the immediate needs of citizens in their geographical area. In particular, these activities involve housing and community amenities, urban planning, municipal services, child and social care, primary health care, child care and primary education, culture, physical education, sports, consumer protection, protection and promotion of natural environment, fire fighting, and civilian protection. Cities and municipalities can take over functions from counties, if they have enough economic capacity.

Croatia has started an ambitious policy of decentralisation in the last few years. A programme initiated in 2001 began to transfer the responsibility for education, health care, welfare, and fire fighting to sub-national governments. Although sub-national expenditure is still small compared to the central government, the decentralisation process increased revenue and expenditures for sub-national governments significantly (see Table 8). Decentralisation has been gradual and functions are being decentralised only if sub-national governments have the ability to perform the services properly.

**Table 8. The budgets of the sub-national sector 1999-2003**

Per cent of general government budget and share of GDP

	1999	2000	2001	2002	2003
<b>Share of general government budget</b>					
Revenue	11.2	12.6	12.9	15.1	16.1
Expenditure	11.1	11.8	12.6	14.3	15.2
<b>Per cent of GDP</b>					
Revenue	5.9	6.2	6.0	7.0	7.5
Expenditure	6.1	6.4	6.2	7.0	7.5
<b>General government expenditure</b>	<b>54.8</b>	<b>54.0</b>	<b>49.1</b>	<b>48.8</b>	<b>49.4</b>

Source: Bajo and Bronić (2005).

Local government revenue comes mainly from taxes and to a smaller extent from grants. Tax revenue is mainly from tax-sharing arrangements, where the central government sets the tax rates and the shares that go to different layers of government. Sub-national governments also receive a significant amount of non-tax revenues, mainly in the form of user charges

for utilities.<sup>23</sup> Most current expenditures are consumption expenditures, but a significant part is also subsidies and other transfers.

With the introduction in 2002 of the Rules on Budget Accounting and Chart of Accounts, the accounts of sub-national governments have to be based on modified accruals for both budgeting and accounting purposes, with revenues on a cash basis and expenditures when obligations are incurred.

**Table 9. Sub-national government revenue and expenditure 1997-2003**

Billion Croatian kuna (the exchange rate is around EUR 0.138)

	1997	1998	1999	2000	2001	2002	2003
<b>Revenue</b>	<b>7.6</b>	<b>8.7</b>	<b>8.4</b>	<b>9.4</b>	<b>10.0</b>	<b>13.2</b>	<b>15.3</b>
Taxes	4.0	4.8	4.6	5.0	5.3	7.1	8.4
of which sub-national surtax on income						0.7	0.8
Grants	0.6	0.8	0.6	0.7	1.0	1.2	1.5
Other	3.0	3.0	3.1	3.7	3.7	4.2	4.6
<b>Expenditure</b>	<b>7.4</b>	<b>8.7</b>	<b>8.7</b>	<b>9.7</b>	<b>10.3</b>	<b>11.7</b>	<b>14.4</b>
Current expenditure	4.9	5.8	6.1	6.8	8.2	9.4	10.9
Capital expenditure	2.5	2.9	2.6	2.9	2.0	2.4	3.5
<b>Net lending</b>	<b>0.2</b>	<b>-0.1</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.3</b>	<b>1.5</b>	<b>0.9</b>

Source: Bajo and Jakir-Bajo (2006).

Sub-national borrowing is limited by the Budget Act (article 105). Prior agreement from the central government is needed for borrowing. Government consent is given if the local unit's annual obligations do not exceed 20% of its revenue of the previous year. The amount of the total annual obligation shall include the amount of annuities on new and existing loans, the debt service (interest and amortisation) on newly issued and existing securities, and the expected calls of new and existing guarantees.

## 6.2. Tax sharing

Shared taxes are the taxes on income, profit and real estate transactions. County and local levels have tax bases of their own, but the tax rates are to a large extent set or restricted by the central government. Since 2002, municipalities and cities can introduce surtax on personal income. This tax has increased revenues significantly since its introduction and is now an important source of revenue for cities and municipalities.

The Croatian tax-sharing system is complicated. The tax that goes to a specific sub-national government is based on taxes actually collected in its constituency. The general shares going to different levels of government are presented in Table 10 but there are exemptions. For example, regarding

personal income, Zagreb receives a different share than the rest of the country, and the tax-sharing system also includes regional policy to improve the revenue for poorer sub-national governments. Furthermore, depending on the degree of decentralisation, additional tax shares are given to sub-national governments. Parts of the taxes go to the Equalisation Fund. The Equalisation Fund is used to transfer additional resources to sub-national governments that have assumed responsibility for decentralised functions when the revenue from the increased tax share cannot fully finance the activity.

The tax share put aside to finance decentralisation of elementary and secondary education, health care, social welfare and fire fighting totals 10.4%. The size of the transferred tax share depends on the responsibilities that the sub-national level has assumed. If a sub-national government only takes over the responsibility for some of the functions, only the percentages associated with those functions are transferred. Tax shares for responsibilities that are not transferred are kept by the central government.

**Table 10. Tax sharing between levels of government in Croatia**

Tax on	Percentage points				
	State budget	Counties	Municipalities/ cities	Equalisation Fund <sup>a</sup>	Decentralised functions <sup>b</sup>
Personal income	24.6	10	34	21	10.4
Personal income, Zagreb	21.6	–	47	21	10.4
Profit	70	10	20	–	–
Real estate sales	40	–	60	–	–

a. The Equalisation Fund is a fund from which resources are transferred to poorer sub-national governments.

b. Transferred functions are elementary education (2.9%), secondary education (2.0%), health care (2.5%), social welfare (2.0%) and fire-fighting (1%). The revenue from these shares remains in the sub-national governments that have assumed responsibility for the function.

Source: Croatian Ministry of Finance.

Since 2001, cities and municipalities can add surtax on personal income in their jurisdiction.<sup>24</sup> As with the general personal income tax, the surtax is payable in the jurisdiction where the citizen resides. The surtax has a maximum rate set by the central government of 10% for municipalities, 12% for cities up to 30 000 citizens, and 15% for cities with more than 30 000 citizens. For Zagreb the maximum surtax is set at 30%. The revenue from this surtax is still relatively small compared to total tax revenue, but is increasing. In 2003, 198 cities and municipalities had introduced this surtax.

### 6.3. Equalisation

The Croatian tax-sharing system includes equalisation of revenue capacity, cost structure and regional policy. This works in two ways, through a special tax-sharing arrangement for areas of special national concern (ASNC) and through the Equalisation Fund.

Areas of special national concern are divided into five groups. Groups one and two consist of areas occupied and damaged during the war. Group three contains areas which lag behind in terms of development. The last two groups are hilly/mountainous regions and islands. About 275 cities/municipalities are regarded as ASNC. For the ASNCs, the central government can transfer its entire own tax share so that these local units can receive 90% of the tax on profits and up to 90 % of the tax on personal income – *i.e.* everything except what goes to the counties (see Table 11).

**Table 11. Tax sharing for areas of special national concern (ASNC)**

Percentage points

Tax on	State budget	Counties	Municipalities/ cities	Equalisation Fund	Decentralised functions
Personal income tax	0	10	90	0	0
Profit	0	10	90	0	0

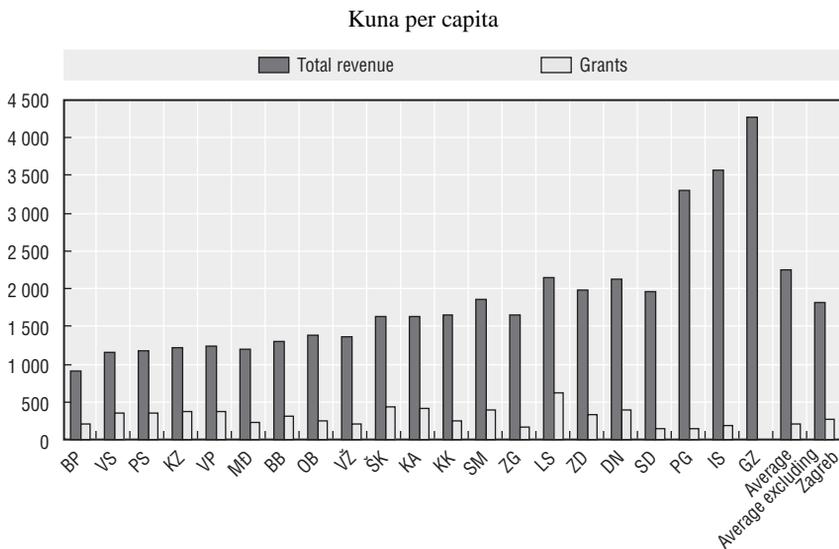
The Equalisation Fund was created to help sub-national governments that cannot provide decentralised functions at a national minimum level from their regular tax share. The Equalisation Fund receives a 21% tax share on personal income tax from areas not belonging to the ASNC group. In addition to the Law on the Financing of Local and Regional Self-governing Units, a decree is passed every year that determines necessary minimum resources for the decentralised functions. This minimum resource is decided by the relevant line ministry together with the Ministry of Finance and set in the Law on Budget Execution. The difference between the minimum resource and the regular tax share is compensated through the Equalisation Fund. On an aggregate level, almost 50% of the cost for the decentralised functions is financed by the regular tax share; the rest is financed through the Equalisation Fund. The funds allocated to the decentralised functions (both tax shares and Equalisation Fund contributions) are earmarked to their specific purpose. The government is aware that this may hamper the efficiency of service provision and intends to move away from earmarking.

## 6.4. Grants

The Croatian government also uses grants to finance sub-national governments. The criteria for the distribution of grants (current and capital) are defined in the annual Law on Budget Execution. Grants are mainly given to counties which subsequently pass on parts of the grants to cities and municipalities. Grants are mainly of a general purpose character and directed towards areas of ASNC (both counties and cities/municipalities). Examples of criteria used to distribute grants are size of population, revenue per capita, and expenditure for capital assets.

Although the general purpose grants seem to be motivated partly by equalisation purposes, the data do not confirm that. As Bajo and Bronić show (Figure 6), grants per capita are distributed quite evenly among counties, independent of total revenue per capita (apart from Zagreb which receives no grants).

**Figure 6. Local government (counties) total revenue and grants in 2001**



Note: GZ is Zagreb; the other acronyms indicate the other counties of Croatia.

Source: Bajo and Bronić (2005).

## 6.5. Conclusion

In Croatia, revenue from tax-sharing arrangements is the most important source of income for sub-national governments. Sub-national governments in Croatia have relatively large own revenues, but little own taxes.

Equalisation of fiscal capacity and service capacity is realised in Croatia with various instruments: tax-sharing, the Equalisation Fund, and grants. The system is rather complex. An important criterion for these various instruments is if a sub-national government belongs to the areas of special national concern. The criteria for belonging to this group are not entirely transparent, which opens the way for lobbying and *ad hoc* political deals. This may reduce the fairness of the system. In general the equalisation aims could be realised by a simpler and more transparent system.

The general purpose grant has an equalisation purpose but the actual distribution of the grant seems not to reflect this purpose.

Tax shares and Equalisation Fund transfers are to a large extent earmarked. This may hamper the efficiency of service provision. It is important that the government's reform plans in this respect are implemented soon.

## Notes

1. The Debt Management Division of the Ministry of Finance is formally responsible for the registration of guarantees. However, its registers were not complete before 2003. In the second half of 2003 the registration of guarantees in the Public Debt Management Sector was improved. Nevertheless, in 2004 the official record in the Ministry of Finance still showed differences with the registration maintained by the Croatian National Bank (CNB) which is based on data originating with the banks (IMF, 2004a).
2. In connection with the stand-by arrangement of 2004, the IMF has published staff reports on Croatian fiscal and structural policies in 2004 and 2005 (IMF, 2004a and 2005). Furthermore, in 2004 the IMF conducted a fiscal transparency review of Croatia (IMF, 2004b).
3. Approved by Parliament on 15 July 2004.
4. For instance moving privatisation receipts (which are means to finance the deficit) to non-tax revenues.

5. In 2001 and 2002 the Croatian Institute of Pension Insurance and the major portion of the expenditures and revenues of the Croatian Institute of Health Insurance and the Croatian Employment Office were included in the state treasury system.
6. Namely Croatian Waters, Croatian Motorways, Croatian Roads, State Agency for Deposit Insurance and Bank Rehabilitation, and the Croatian Privatisation Fund.
7. For instance, the HBOR is exempt from tax.
8. For instance, certain budget users are compelled to hold accounts with the Postansk Bank.
9. For example, for an enterprise in the Privatisation Fund portfolio, it is not clear whether the line ministry or the Fund has the final responsibility for the decision on a loan guarantee before it goes to the Ministry of Finance for approval (IMF, 2004b).
10. The United States uses multi-year estimates based on current law, but this is largely due to the dominant position of the US Congress in the budget process. The Congress cannot be confronted with policy decisions from the executive branch that are not yet enacted in law.
11. Official Gazette no. 96/03 and Official Gazette no. 171/04 for the Law on Budget Execution for 2005.
12. SAP stands for System, Application and Product and is a management system produced by a company of the same name (SAP).
13. The Croatian National Bank is independent according to Article 53 of the Constitution. It is not involved in quasi-fiscal activities (IMF, 2004b), and since 2001 it is prohibited from providing credit to the government (Article 36 of the Law of the Croatian National Bank).
14. Usually updated budgets are presented only once or twice to Parliament during the execution year (supplementary budgets). However, within the executive branch, updating should be a permanent activity.
15. An exception is guarantees to international financial institutions, which are handled by the Department for International Financial Institutions and European Integration (within the Ministry of Finance).
16. Two examples are the Act on the Organisation and Competences of Ministers and State Administrative Organisations (2003, with amendments in 2004) and the revoking of the Regulation on the Principles of Internal Organisation of State Administrative Bodies. Revoking the last regulation removed some regulations regarding quotas and numbers of public civil servants in internal organisational units,

contributing to a more effective organisation of central government bodies.

17. So far, a single person has occupied this office since its creation. Parliament appointed the first Auditor General in 1994, and her mandate was renewed in 2002.
18. Section 13.1 of INTOSAI's *Lima Declaration of Guidelines on Auditing Precepts* states: "Supreme Audit Institutions shall audit in accordance with a self-determined programme." See [www.intosai.org](http://www.intosai.org).
19. In comparison, Slovenia has chosen an interesting compromise between parliamentary involvement and audit independence. The Court of Audit of the Republic of Slovenia is required to consider at least five proposals for audits from the National Assembly (Kraan and Wehner, 2005, p. 93).
20. SIGMA (OECD, 2002b) estimated in 2002 that up to half the audit activity was absorbed by privatisation audits.
21. Hence the development of internal audit capacity is also an issue for other accession candidates. The situation in Romania, for instance, is considered in Ruffner *et al.*, 2005, pp. 42-43.
22. These documents are available at [http://pifc.mfin.hr/home\\_en.htm](http://pifc.mfin.hr/home_en.htm) ["Development of Public International Financial Control (PIFC) in the Republic of Croatia"].
23. The legal framework regulating sub-national governments' financing can be found in the following documents: the Budget Act, the Law on the Financing of Local and Regional Self-governing Units, the Law on Budget Execution, the Decree on the Mode of Calculation of Equalisation Grants for Decentralised Functions, the Rules on Budget Accounting and Chart of Accounts, and the Rules on Financial Reporting in Budget Accounting. In addition to this, sub-national governments have to follow other laws and rules that regulate various areas of public spending.
24. Before 2001, only cities, including Zagreb, were allowed to introduce surtax on personal income.

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