



**SIGMA**

**Support for Improvement in Governance and Management**

A joint initiative of the OECD and the European Union, principally financed by the EU

**CROATIA**

**PUBLIC EXPENDITURE  
MANAGEMENT SYSTEM**

**ASSESSMENT MAY 2009**

## 1. Summary

### *Main Developments since last year*

Since the general elections of November 2007 the public expenditure management system in Croatia has seen steady development in many of the core areas. Due to the elections the general reform process slowed down in 2007, but since the formation of the new government the Treasury Reform Strategy (adopted just before the elections in October 2007) has been the basis for the reforms implemented by the civil service. Since the last assessment of May 2008 the Croatian authorities have managed to implement many of the planned changes in the public finance management system. Many projects for improving the budget and treasury systems have started, and there is a rather good outlook for progress in the development of the public expenditure management system. No doubt the perspective of joining the EU in the coming years has had a positive impact on the readiness to implement the necessary changes. The key change during the past year was the adoption of the new (organic) Budget Act, which provides a much firmer basis for a multi-annual budgetary framework.

The key determinant demonstrating good fiscal policy is the process of fiscal adjustment. Fiscal consolidation and reduction of the overall budget deficit will have an impact on the financial stability of the country. (Instead of the increase of wages for civil servants foreseen in the 2009 budget, a 6% decrease of the civil service wage bill was under negotiation at the time of writing). The years 2006 and 2007 can be seen as years of fiscal consolidation – the overall budget deficit was reduced from 4.3% of GDP in 2004 to 1.4% in 2007. For the years 2008 and 2009 the Government of Croatia had the objective of continuing to improve the fiscal stance; however, the weakening economic situation has led to increasing deficit figures. In 2008 the latest figures show that the general public deficit was 1.1%. It is difficult to estimate the deficit for 2009; however, in order to reduce the total deficit, the Croatian National Assembly has adopted in 2009 the first supplementary budget, reducing expenditure for a total amount of 5.4 billion HRK (1.6% of GDP).

### *Main Characteristics (strengths and weaknesses)*

Although considerable progress has been made in the past year, continued development of the public expenditure management system is necessary. For instance, parliament continues to play a very modest role in the area of public finances. Parliament has only marginal time available for discussions before the adoption of the budget and its tools for scrutinising the annual final accounts are limited. The budget documentation itself is also very detailed and difficult to understand. Despite an existing rule that only 5% of the budget may be reallocated, the government is still given unlimited authority in the Budget Execution Act for 2009 Budget for the reallocation of funds without any specified limit. There is also room for improving the accounting systems of line ministries and linking the electronic accounting systems of main budget-users with the Treasury's financial management information system. Many of the new procedures still have to be tested in practice.

### *Recommendations for Reform*

Most of the recommendations below should be regarded as related to mid-term objectives.

- Reconsider the future role of parliament in the budget process, as defined in the new Budget Act;
- Revise the budget calendar in such a manner that the preparation of the annual budget proposal starts earlier (e.g. mid-February) and the state budget proposal is submitted earlier to parliament (e.g. 1 October);
- Proceed as soon as possible with government approval of the secondary legislation foreseen in the new Budget Act that has not yet been passed or approved; in the medium term, merge the strategy of government programmes with economic and fiscal policy guidelines or convene parliamentary discussion on these documents at the same time;

- Decrease the total number of first-level budget-users in order to reduce the workload of the Ministry of Finance and to give room to the line ministries for policy co-ordination in their respective areas;
- Reconsider the level of Treasury control: moving from the fourth level to the third level is a step forward, but still means a level of detailed controls. However, the underlying objective of the new Budget Act – the introduction of performance management in the Croatian public administration – implies the introduction of other (decentralised) information and control systems as well assistance to managers in achieving their objectives;
- Give priority (by the government) to aligning statistical definitions of the government sector and finances with the ESA 95 standard;
- Enhance the methods used for preparing macroeconomic forecasts and align the information presented more closely with practices in EU Member States;
- Prepare and approve (by the government) the pre-accession economic programme, preferably in November;
- Introduce the Ministry of Finance's role in the capital budgeting process to key players in this process as soon as the foreseen decree on capital budgeting has been approved by the government;
- Simplify the detailed monthly cash planning for the execution of the state budget; Strengthen the professional capacity of budget preparation sectors in ministries, giving priority to the linkage between the budget and overall and strategic planning;
- Expand the Treasury Single Account (TSA) system so that it covers all payments and revenues;
- Improve the system for registering information on payment commitments by creating possibilities for registering commitment information for subsequent years;
- Prepare a strategic decision regarding the bases to be used for budgeting and accounting.

Some of the recommendations listed above have already been included in the Treasury Reform Strategy, which is being implemented with the support of a large technical assistance project. Furthermore, the technical preparations for foreign currency transactions within the Treasury Single Account are the subject of another TA project.

Some of the above recommendations, however, have not yet been discussed, enough among national authorities. They can be considered as suggestions for action from a medium-term perspective.

## 2. Budget Legislation

The Constitution of Croatia contains very few provisions regarding the distribution of fiscal powers between parliament and the government. It is stated that parliament is to adopt the state budget (art.80), that state revenues and expenditure are to be determined by the state budget (art. 90), and that the government is to propose the state budget and the annual accounts (art.112).

In the Standing Orders of Parliament, there is a section on “Passing the Central Budget”; however, for the most part it simply repeats the provisions that already exist in the Budget Act. Only the procedures for the debate and vote on the budget provide some further regulation as compared to the Budget Act, but these rules are fairly similar to the general procedures for enacting laws.

The new Budget Act, which was adopted on 15 July 2008 and came into effect on 1 January 2009, contains some 130 articles and covers most of the relevant issues that should be laid down in an organic budget law. The Act regulates annual strategic planning, preparation and passage of the budget, execution of the budget, asset and debt management, borrowing and the guarantee of the state and local governments, accounting and budgetary control.

The main changes in the new Act compared to the Budget Act of 2003 are the following:

- Clear procedures for annual strategic planning by the government;
- Specific provisions for the multi-annual budgetary framework (the annual budget is now adopted by parliament for one year, together with estimates for the following two years);
- Fiscal estimations are also compulsory for strategies and projects (previously they were required only for legal acts);
- Further development of programme budgeting by establishing clearer provisions for performance indicators;
- Reduction of the level of detail in the budget appropriation (the number of line items in the annual budget has been reduced from the previous four-level categorisation to three levels);
- More stringent regulation regarding borrowing by local governments.

Although the law in many aspects is rather detailed and describes the conduct and procedures to be followed between government bodies, it also includes a few delegation norms. In most aspects it indicates that detailed provisions are to be included in a rulebook (to be approved by the Minister of Finance). In a few cases the law foresees a decree by the government. Compared to the previous Budget Act, the new Act has fewer pieces of secondary legislation. In May 2009 most of the secondary legislation foreseen by the new Budget Act has not yet been finalised, although the Budget Act established a deadline for this work of end April 2009. Until the new regulations and decrees are approved, the respective secondary legislation adopted under the Budget Act of July 2003 remains valid (this includes regulations for the previous way of classifying the budget, chart of accounts, etc.).

The Budget Act foresees a specific feature according to which parliament, at the same time as it approves the state budget, adopts by separate vote an annual Act on the Execution of the State Budget. This Act regulates further details regarding revenue, expenditure, guarantees, borrowing, debt, etc., and provides the government with more freedom than the Budget Act alone would do.

The Constitution, Standing Orders of the Parliament, Budget Act, and Act on the Execution of the State Budget together contain the necessary provisions for regulation of the preparation, approval and execution of the state budget. However, it is a disadvantage that the rules laid down in the Constitution and in the Standing Orders of Parliament are so brief and that even fundamental provisions for the regulation of fiscal powers are included in the organic Budget Act. This means that some fundamental rules can be changed by a majority vote of all members of parliament.

**The legal budgeting framework has been improved by the adoption of the new Budget Act. Important issues, such as strategic planning and the multi-annual framework, are sufficiently regulated. Some crucial provisions regarding the distribution of powers between parliament**

**and the government are also regulated in the new Budget Act, although it would be preferable to include these provisions in the Constitution.**

**Although the approval of the new Budget Act is an important step forward in the development of a robust legal budgeting framework, this framework is not yet complete as it lacks the necessary secondary legislation.**

### **3. Parliament/Executive Relationship**

As was the case with the previous version of the organic budget law, the new Budget Act sets the deadline for submission by the government of the budget proposal at 15 November.

According to the Standing Orders, parliament closes by 15 December. This leaves parliament 30 days to analyse, debate and vote on the state budget. Given the detailed line-item structure of the budget, parliament has comparatively little time for the approval of the state budget.

In the OECD's *Best Practices for Budget Transparency*, it is stated that in no event should the draft budget be submitted to parliament less than three months prior to the start of the fiscal year.

Parliament's powers to change the proposed state budget are limited. According to the Budget Act, any increase in budget expenditure must be compensated for by a simultaneous proposal for reduced expenditure. It is noteworthy that any changes in the direction of greater expenses proposed by parliament cannot be covered by additional state borrowing but have to be strictly compensated for by a reduction of expenditure somewhere else. The government also needs to approve or at least needs to give an opinion on any changes proposed by members of parliament.

Another interesting feature concerns the decision-making process within the government. In the event that the Ministry of Finance and the budget-users cannot agree, the Budget Act foresees that the decision for resolving the dispute is to be made by the prime minister. This provision clearly strengthens the role of the prime minister in decision-making processes, although in practice these modalities depend mostly on the particular persons in these decision-making positions.

There are also rules regarding the preparation and adoption of the semi-annual and annual statements of budget expenditure (see section 8 below), although at the moment parliament is not using these tools effectively, which is partly due to the fact that these statements by the government are not scrutinised by the State Audit Office.

**Compared to other countries, the authority of the Croatian Parliament to propose changes in the annual budget is still limited. It is disappointing that the new Budget Act still allows a very short time period for parliament to review, debate and adopt the state budget, which puts parliament at a disadvantage. Extending this time period would contribute to fuller parliamentary involvement and commitment to the approved state budget. Also involving parliament in the discussions on medium-term strategic documents (namely the strategy of government programmes and the economic and fiscal policy guidelines) may enable it to take a more effective role in shaping budget priorities.**

### **4. Scope of the State Budget**

At the same time as the draft state budget is submitted to parliament, draft financial plans for extra-budgetary funds are also submitted. In addition, a consolidated state budget is presented. Thus parliament has access to all central government budgets when it discusses and adopts the various budgets. The budget documents include all state revenues and expenditures, including the funds foreseen from the EU and other donors.

The state budget 2009 is a typical line-item budget and still includes some 7000-9000 lines. As from the 2010 budget, the level of detail will nevertheless be reduced, as the new Budget Act foresees less detail in the economic classification. From a performance budget perspective, which emphasizes the responsibilities of managers to deliver value for money (quality of expenditures), an even smaller number of budget lines is indispensable.

The state budget is divided into a general part and a special part. In the general part, revenues and expenditures are structured according to economic categories, and in the special part expenditures are structured according to main budget-users, programmes and expenditure categories.

According to the new Budget Act, revenues and expenditures have been divided into eight categories of economic classification. The economic classification is presented and approved on a three-digit level for the first year and on a two-digit level for the following two years (the 2009 budget still contains information on a four-digit level). The budget is presented on a gross basis, and all revenues and expenditures seem to be included.

All expenditures are divided between first-level budget-users and programmes. Although the programme structure was introduced a few years ago, the focus of budget discussions is still on input. The current structure of the programmes of ministries reflects in many cases the administrative structure of the ministry. The programmes in the state budget also include a results assessment; however, in practice the use of performance indicators is limited and is better developed in the areas that are covered by components III, IV and V of the IPA.

An ongoing project for developing the use of performance indicators is being carried out in some pilot ministries. Development of the use of performance indicators, together with the new strategic planning concept, may result in many changes to the existing programme structure in ministries.

The limits for borrowing are determined by the State Budget Execution Act. It clearly establishes the total amount of new state debt and state guarantees that may be assumed or issued during the fiscal year. This Act also foresees restrictions in connection with borrowing by local government units and extra-budgetary funds. There is a long-standing tradition in Croatia to use the IMF General Finance Statistics (GFS) 1986 and 2001 classifications. There have therefore been uncertainties as to how some institutions and transactions should be classified in order to achieve full statistical compliance with European System of Accounts (ESA) 95 definitions of the general government sector and its sub-sectors and of net lending/borrowing. Together with the Bureau of Statistics and the National Bank, continuous efforts are being made to reconcile current statistics with the ESA 95 standard. The first Fiscal Notification of Croatia, which was submitted in the spring of 2005, was based on GFS 2001, and adjustments were later made in order to achieve a rough compliance with ESA 95, according to which the second Fiscal Notification was submitted in the spring of 2006 and in subsequent years. One of the objectives of a two-year CARDS twinning project, "Public Finance Statistics" 2006-2008, was to provide reliable, internationally comparable and inter-institutionally harmonised data on public finance. Progress has been achieved; however, in 2009 the full harmonisation between the national accounts and the Fiscal Notification is still an ongoing process.

Quarterly national accounts data as from 1997 is available from the Croatian Bureau of Statistics.

**It is not time and resource-effective to continue for a longer period with both line-item information and programme information in the same budget document. In a medium-term perspective it is recommended to integrate these two types of information so that the budget is presented in a single programme structure. The information on economic classification could be part of each programme and the level of detail could be reduced gradually so as to direct the budget discussions more towards objectives and financing of the different programmes.**

**The government should give high priority to aligning statistical definitions of the government sector and finances with the ESA 95 standards.**

## **5. Medium-Term Expenditure Framework**

The new Budget Act introduces a systematic concept for annual strategic planning, which is co-ordinated by the Ministry of Finance (state budget sector) in co-operation with the Central Office for Development Strategy and Co-ordination of EU Funds.

In short, the concept foresees that in spring all first-level budget-users (around 50) prepare their strategic plans for a three-year period, which are submitted to the Ministry of Finance by 15 April. On the basis of these strategic plans, the Ministry of Finance, in co-operation with the Central Office for

Development Strategy and Co-ordination of EU Funds, prepares the strategy of government programmes for the same three-year period and proposes the strategy to the government. The strategy of government programmes is to include joint vision, main strategic areas of government with identified goals, ranked strategic priorities, and measures for achieving these goals. The Budget Act does not foresee the inclusion of any financial information in these strategic plans.

As the co-ordinated strategic planning exercise is being carried out for the first time in 2009 and in a very short time frame, it can be anticipated that the quality of the strategy of government programmes may be poor. As there are around 50 first-level budget-users, all of whom submit their strategic plans at the same time, it will be an enormous challenge for the Ministry of Finance to determine the main strategic areas and objectives of the government in only a few weeks' time. Nevertheless, even if it is carried out superficially, this exercise has clear positive aspects. Firstly, it will provide the Ministry of Finance with the necessary information for proposing budget ceilings for first-level budget-users. Secondly, it will provide the basis for better strategic budget planning in the years to come. The strategic planning exercise might gradually also improve the quality of programme budgeting, more specifically objective setting and choice of performance indicators.

The strategy of government programmes does not have to be presented to parliament for debate. We have been informed that the Ministry of Finance is nevertheless open to present the strategy for information to parliament but would like to wait until the results of the first attempt are clearer before making any firm commitments.

Strategic planning in general is not new to Croatia. Many ministries have developed their strategies, which have also been formally co-ordinated and adopted. There are around 120 different sectoral strategies, some of which have been adopted by the government and some by parliament. Most of these strategies include information on the required finances, and all of them are sent to the Ministry of Finance for its opinion before being proposed to the government. The sectoral strategies will be the basis for the government strategy; the Ministry of Finance will continue to scrutinise these documents.

In the spring the Bureau for Macroeconomic Analysis and Planning of the Ministry of Finance also prepares the economic and fiscal policy guidelines for a three-year period, which are sent to the government two weeks after the approval of the government programme and are to be approved by the government two weeks thereafter. This document provides comprehensive macroeconomic projections, fiscal objectives, estimates of expenditure and revenue in government sectors, expenditure ceilings for budget-users, etc. The projections are compared to the deficit and debt requirements of the Maastricht criteria. The guidelines constitute the basis for preparation by the government of the Pre-Accession Economic Programme (PEP) and are in line with the Strategic Development Framework 2006-2013. The Bureau has more than ten staff members. This is not many considering that the Bureau also co-ordinates EU own resources and harmonisation of ESA 95 issues.

The Bureau for Macroeconomic Analysis and Planning maintains a professional exchange of views with the Zagreb Institute of Economics, the Institute for Public Finance, and the Research Department of the Croatian National Bank. The National Bank uses a simple IT-based economic model provided by the International Monetary Fund. An update of the macro-analysis model is needed.

So far there is no practice of organising debates in parliament when the economic and fiscal policy guidelines are released by the Bureau. To increase transparency and strengthen political commitment, consideration should be given to organising discussions regarding the budget ceilings at least so as to provide a generally accepted framework for the end-of-year budget discussions.

The economic and fiscal policy guidelines and the Pre-Accession Economic Programme are the two key outputs of the Bureau for Macroeconomic Analysis and Planning. The guidelines, which also set the annual ceilings for budget-users, are more or less in line with similar guidelines of the new EU Member States. However, areas that analyse and summarise the economic trends of the country need to be further developed, for example more detailed information should be provided on the budget balance (including the cyclical stance of the public balance) and on sensitivity checks for larger GDP components, such as productivity and labour utilisation, which could provide a basis for a comprehensive presentation of various risk scenarios.

The second important document prepared by the Bureau – the Pre-Accession Economic Programme – in previous years was submitted to the government for approval in November. It has now been decided that the government should discuss and approve the Programme in January. As the document will become, following EU accession, a Convergence Programme, which has to be submitted by 1 December, it would be worthwhile to consider changing the deadline back to November.

**The Croatian authorities intend to implement a more coherent medium-term fiscal framework, which will gradually provide a solid basis for the budget process. Currently the government approves two separate documents (the strategy of government programmes and the economic and fiscal policy guidelines) within a two-week period. In the medium term it is recommended to merge these two documents or to discuss them in parliament at the same time.**

**The Croatian authorities should consider the future adoption by parliament of the medium-term budgetary framework (the strategy of government programmes and the economic and fiscal policy guidelines) or a summary of that framework together with the adoption of the annual state budget.**

## 6. Budget Process

An important key player in the budget process is the Treasury Directorate, which consists of the Budget Preparation Sector and Local and Regional Self-Government Units' Financing, the State Budget Execution Sector and the Public Debt Management Department. The Budget Preparation Sector comprises five divisions, namely state budget preparation, local and regional budgets, budget consolidation, fiscal analysis and capital investments. The Budget Execution Sector comprises three divisions, namely budget execution, accounting and budget inspection. The number of staff in these units has increased over the past year. To raise the capacities of the Budget Preparation Sector it is important to increase the professional skills of current staff rather than increasing the number of staff.

The various steps in the budget preparation process are generally well defined in the Budget Act. Based on the strategy of government programmes and the economic and fiscal policy guidelines (see section 4 above), the Ministry of Finance prepares and issues instructions to budget-users for the preparation of the fiscal plans that they must submit to the Ministry of Finance. According to the Budget Act, the Ministry of Finance submits similar instructions to local government units. The contents of the instructions correspond to the usual contents of a budget circular.

Once the Ministry of Finance has finalised the draft budget for the budget year and the projections for the following two years, they are submitted to the government for approval. Parliament approves the budget by the end of the year, but sessions of parliament are planned only until 15 December.

The role of the Ministry of Finance – the Budget Preparation Sector in particular – was strengthened by a provision stating that the Ministry of Finance was to approve an assessment of the fiscal impact of all new laws and regulations. This procedure, introduced in June 2005, includes a standard methodology, with forms prescribed by the Ministry of Finance. The full implementation of this new practice took place in 2006, thus allowing the introduction of some improvements to the methodology as well as to the form used. In 2008 these rules and forms were brought in line with the new Budget Act, which means that the information on fiscal impacts now needs to be submitted also for strategies, projects and programmes. A web application is being developed by the Ministry of Finance in order to collect data relevant to the fiscal impact assessment, improve communication between the Ministry of Finance and budget-users, and improve the link between the fiscal impact assessment and the medium-term expenditure framework.

The draft budget submitted to parliament includes proposals for the first fiscal year and estimates for the two following years. This is consistent with the medium-term fiscal framework, but its value has to be proven in practice. The question is whether the estimates for the two following years are counted on also in the spring of the following year when another budget preparation cycle begins.

The explanations submitted to parliament concurrently with the draft state budget are prepared in the Ministry of Finance based on material provided by line ministries. The detailed nature of the draft

budget makes it difficult for members of parliament and the general public to fully understand the content and implications of the budget proposal, although the current and planned level of detail is said to comply with the requests of most members of parliament.

**The process of drafting the annual budget could start earlier in the year. Submitting the economic and fiscal policy guidelines for adoption two weeks earlier in the year together with the strategy of government programmes would enable the Ministry of Finance to issue instructions to budget-users by the end of May. Continued efforts should be made to present the budget in programme terms. The strategic planning exercise, together with a stronger focus on performance indicators, should provide good support for such a presentation of the budget. The draft state budget, including extra-budgetary financial plans, should be submitted to parliament earlier in the autumn (1 October would be a feasible date).**

## **7. Budget Management of Public Investments**

The Budget Act includes provisions for the preparation of investment programmes. The Ministry of Finance's knowledge of capital investment is still very limited. The ministry is not involved with major investment organisations, such as the motorways, and needs to have better control of investment, irrespective of how or by whom it is financed. At the moment the Ministry of Finance is only aware of about one-third of investment spending. Furthermore, there is no separation within the budget between current and capital spending, which could lead to a leak of capital spending into current spending. However, the Ministry of Finance is preparing a decree that would prescribe the methodology for preparation, evaluation and execution of government investment projects. This decree is planned to be adopted by the government in May 2009. The current plans foresee that the decree would be accompanied by more detailed guidelines regarding the preparation and presentation of investment or development programmes.

The preparation of current expenditure and investment expenditure is integrated in the budget process. The same applies to EU pre-accession funds, which also finance many investment projects. In the budget preparation process the Ministry of Finance, together with the Central Agency for Financing and Contracting of EU Programmes, also discuss with budget-users the accurate amounts of EU projects for a three-year period. .

The funds received from the EU and other donors can be carried forward to the next year if the planned budget is not entirely spent. The same principle also applies to all capital expenditure.

The rules established by the government for fiscal impact assessment also apply for capital investment projects, as they do for strategies, policies and legislation. The current assessment has not analysed the quality of fiscal impact assessments carried out for investment projects, but the general procedures for informing the Ministry of Finance and the government are sound. According to the rulebook, all budget-users are obliged to send a declaration of fiscal impact assessment to the Ministry of Finance. The declaration, accompanied by a table with detailed information on various costs and revenues, receives the opinion of the Ministry of Finance.

The Budget Act rightly stipulates that funds from the sale of non-financial fixed assets are to be used exclusively for capital expenditure of the state.

**In addition to the government decree on investment projects, written guidance and methodological support needs to be provided for all budget-users. These materials should be accompanied by relevant training modules for various groups of budget-users and for various roles within budget-users.**

## **8. Budget Execution and Monitoring**

Once parliament has approved the state budget, preparations are made for its execution. An important element in the execution is the preparation and execution of monthly cash appropriations for each budget-user.

Budget-users submit plans to the second sector of the Treasury Directorate, the Budget Preparation Sector, which checks that these plans are consistent with the approved budget and with revenue projections. The Budget Execution Sector approves cash execution plans on a monthly basis for each of the main budget-users (around 50) on the same detailed level as the budget adopted by parliament.

The information system on payments, which includes information on invoices and contracts, has been operational for several years now.

Budget-users enter payment requests in the State Treasury Information System in compliance with the monthly cash plan. The State Budget Execution Directorate approves each payment or group of payments. This implies that considerable efforts are required for cash planning and for the execution of payments. The Ministry of Finance is working on establishing the necessary electronic systems for certification and e-signature. The workload will be reduced with e-payment orders and e-payment requests. During the year 2008 the information exchange on commitments was improved, providing monthly data as well as annual commitment information. However, payment commitments can only be recorded in the system for the ongoing budget year. The creation of possibilities for registering commitment information for the following years will support the current rules according to which multi-annual commitments are also allowed.

New commitments can in principle be made only for a calendar year, but multi-annual commitments are also possible. To do this, the budget-user concerned must submit the relevant decision to the government for approval.

At present the Ministry of Finance approves monthly budget releases. It is suggested that in the medium term the Ministry of Finance should consider moving to quarterly budget releases in order to reduce administrative burdens.

Liquidity plans are monitored closely and regularly communicated between the Treasury Directorate and the Public Debt Directorate. The Liquidity Board meets weekly.

Advance payments are possible only exceptionally and with the consent of the Ministry of Finance. However, on the basis of the State Budget Execution Act parliament can authorise budget-users to make advance payments without the consent of the Ministry of Finance. These provisions are normally applied in relation to EU-financed projects, where the standard contract formats foresee various advance payment schemes. The State Budget Execution Act for 2009 Budget has established narrow financial limits for more independent advance payments, and no specific purposes have been defined for which the consent of the Ministry of Finance would not be required.

During the execution phase, it is possible to take some specified temporary measures to reduce expenditure, if necessary, so as to preserve the budget balance. The Budget Act foresees the possibility for the government to suspend specific expenditures or to stop the assumption of liabilities.

The very detailed budget will inevitably lead to a large number of changes. According to the Budget Act, the Minister of Finance is allowed to reallocate funds between budget items and between budget-users for an amount of up to five per cent of the concerned items. The Budget Execution Act, however, gives more flexibility to the government. The Budget Execution Act for 2009 Budget, for example, allows the government to make reallocations in the budget without specifying any limit; the government only needs to inform parliament of the changes within 15 days. This provision seems to reflect the practice of recent years, and despite the very detailed line-item budget, changes to the budget are not very difficult to make.

Normally, appropriated funds that are not spent by a budget-user during the fiscal year cannot be carried over to the next year. However, according to the new Budget Act, donations and foreign aid, capital investments, and earmarked revenues can be carried forward with the consent of the Ministry of Finance. Furthermore, the State Budget Execution Act foresees various procedures and limits for carrying funds over to the next year as well as in other budget categories.

The Treasury Single Account (TSA) was introduced in 1996 and has been improved over the years. The TSA is held in the Croatian National Bank, but management of payment operations is outsourced to FINA. In the year 2006 the accounts of the first and second-level budget-users in commercial banks

were closed as well as those of social funds. In principle, all first and second-level budget-users are included in the TSA system, and all state payments and realised revenues are channelled through the TSA. The Budget Act prescribes that the state budget is to have a single account for all payments. Foreign currency accounts, however, are still not part of the TSA. A technical assistance project is underway to extend the coverage of the TSA to foreign currency accounts.

FINA reports frequently (daily, weekly, monthly) to the Ministry of Finance and to budget-users on the receipts and expenses paid through the TSA. In principle, data is available on a real-time basis, which allows close monitoring of the implementation of the state budget.

In a long-term perspective, once many of the new IT tools are further developed, it might be worthwhile to analyse whether FINA in its intermediary role can still deliver on a cost-effective basis. Integration of cash management and debt management will help to streamline payment procedures and enhance the Treasury's own capacities. So far there has not been substantial discussion on the matter in Croatia. Also, the strategy for the development of the Treasury does not discuss the future relationship between the Treasury and FINA.

The Budget Inspection Service in the Ministry of Finance can follow these funds wherever they are channelled, which reduces the risk of deliberate misuse of funds. The Budget Inspection Service, which is located in the Treasury and is separate from the audit services, can also inspect local government units.

**The preparation and implementation of monthly cash planning requires substantial resources in the Ministry of Finance and in all budget-users. In the medium term it should be possible to reduce the workload by reducing the number of details in cash planning. The TSA system should have complete coverage by including foreign currency transactions.**

**Although the annual budget is adopted by parliament in relatively great detail, in practice the government can adjust the budget more flexibly, as the State Budget Execution Act (which is adopted each year together with the annual budget) does not prescribe any real limits for reallocation between budget items.**

## 9. Accounting and Reporting

The Budget Act identifies IPSAS standards<sup>1</sup> as a principle for accounting, although these standards are not applied in practice. What matters in this regard are the accounting policies. Even with many different policies, the same IPSAS standards can still be applied.

In practice, however, budgeting and the approved state budget are on a strictly cash basis. Consequently, the reporting and monitoring of implementation of the budget are also in cash terms.

However, the accounting of ministries and other budget-users is carried out on the basis of what could be referred to as modified accruals, which means that revenues are recorded when cash has been received by a state budget-user, and expenditures are charged to the accounts when an invoice has been received. If line ministry accounts are based on modified accruals and the budget is based on cash reconciliation (monthly and at year-end) this might cause problems. The technical assistance for Treasury reform will account for the current differences between the Treasury information system and accounting systems in line ministries.

The Minister of Finance has issued the required regulations for accounting, including the chart of accounts and classifications, but these regulations correspond to the previous version of the Budget Act. The core Government Financial Management and Information System (GFMIS) is currently being developed and improved in order to provide efficient support to the overall budget process. The applied system is not linked directly to budget-users' accounting systems, which means that repeated entries have to be made in different systems, with unnecessary work and errors as consequences. In March 2009 the Ministry of Finance launched an 18-month project, which is expected to contribute to the harmonisation of the Treasury's financial management information system with the systems

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<sup>1</sup> IPSAS = International Public Sector Accounting Standards

existing in budget-users by creating adequate interfacing and allowing data exchange and inter-operability.

Accounting does not automatically link transactions with EU funds, but information on these transactions is inserted, with a short time lag, in the general ledger, which is manually based on the detailed reports of the National Fund<sup>2</sup>.

For future purposes, the Ministry of Finance has already determined minimum standards for any new development of financial management information systems within budget-users.

In addition to the extensive rules on reporting that can be found in the Budget Act, the Minister of Finance has also issued the required detailed regulations for reporting. All state budget-users must deliver monthly, quarterly, semi-annual and annual statements; local budget-users submit quarterly, semi-annual and annual statements. These reports are based on accounting figures, not on payments. The reports are consolidated at various levels (see reconciliation problems above).

A semi-annual statement on budget execution must be forwarded to parliament by 15 September. The contents of this statement are elaborated in the Budget Act and in the rulebook issued by the Minister of Finance.

In the Budget Act precise dates are set for the submission of the consolidated statement of the budget accounts by budget-users, line ministries and the Ministry of Finance. The annual statement of budget accounts is usually submitted to parliament at the beginning of June and approved by parliament by the end of June. This time frame is satisfactory. However, it is surprising that the State Audit Office's audit report is submitted to parliament only in October or November. Parliament therefore approves the accounts before having received the auditor's opinion. The State Audit Office should change its procedures and practice and report to parliament on the audit of the annual statement of the budget accounts at the same time as the government submits the annual accounts to parliament.

**A strategic decision still needs to be taken regarding the bases for budgeting and accounting. In the present situation, it seems appropriate to continue budgeting on a cash basis. In the event that consideration is being given to moving in the direction of more or less full application of accruals for accounting purposes, this should be regarded as a medium/long term perspective. Such a change would require a clear strategy on the part of the Croatian authorities to develop sufficient professional accounting skills, accounting policies, and complete and accurate registers for financial and non-financial assets of budget-users at all (including ministerial) levels. Further integration of the financial management, budget and accounting systems remains desirable. It is expected that the upcoming additions to the FMIS set-ups will contribute to this development.**

**The fact that parliament approves the final accounts before it has received the State Audit Office's opinion is not in line with standard practice. Consideration should therefore be given to submitting the final accounts to parliament and to the SAO earlier in the year, e.g. in late April. The SAO should develop its work in such a way as to be able to present its opinion within six to eight weeks. In that way, parliament would have the necessary information for approval of the final accounts before the summer or at least before it has to deal with the new budget in the autumn.**

## **10. Capacity for Upgrading the Public Expenditure Management System**

The Ministry of Finance units mainly concerned by this review are the Bureau for Macroeconomic Analysis and Planning and the State Treasury.

The greatest staff deficiencies, compared to the positions foreseen in the systematisation, are in the Treasury's Unit for Development and Support, which is separate from the two core sectors mentioned above. This unit is in charge of the crucial IT development projects within the Treasury.

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<sup>2</sup> The National Fund is a unit in the management system for the Instrument for Pre-Accession Assistance (IPA) that is responsible for financial management.

The unit is managing, in co-operation with other departments and FINA, several key IT projects to support work in the area of public finances. For the core activities of budget execution, many projects have been carried out and some crucial modules are being finalised. However, new projects are in the pipeline, some of which also support the budget preparation process.

Although not strictly necessary (outsourcing of IT services is very often used as an alternative), in the Croatian situation it is an advantage to have within the Treasury a Unit for Development and Support. This unit mainly concentrates on IT development, but the important aspect is that it has been placed under the same general management as other core functions of public expenditure management. Another advantage is that the various units involved in the budget process are all organised within the State Treasury, the head of which is in close contact with the Minister of Finance.

The staffing situation in the budget and financial management departments within line ministries varies across budget-users. In a few ministries staffing does not seem to be a major source of concern, whereas many finance departments are very small and do not have qualified staff to negotiate with the Ministry of Finance. The situation could potentially improve when the IT project linking the accounting systems of the 80 budget-users to the Treasury system delivers its results at the end of 2010. Improved accounting systems might free human resources from entering duplicate information into different systems and thereby make it possible to fill the partial gaps that exist in strategic planning, fiscal analysis and other areas. (However, there are examples showing that the introduction of new accounting systems has generated the need for more manpower.)

The key document, the Treasury Reform Strategy, was finalised in the summer of 2007 and formally adopted by the government on the eve of the elections in October 2007. Implementation of the strategy has been carried out with reasonable commitment, and several material changes have been implemented since last year's assessment.

There are signs, however, that the general reform pace has not been maintained, but these signs are at a more technical level, e.g. preparing and approving more detailed regulations foreseen by the Budget Act.

Despite the fact that the situation has been improving over the years, staff turnover is still considered as one of the greatest challenges for establishing a strong co-ordinating function in the Ministry of Finance and, in a wider perspective, an effective system of public expenditure management.

## **11. Recommendations for Assistance**

The Croatian authorities are aware that its public expenditure management system has a crucial function in the accession process. It is the general impression that the Croatian Ministry of Finance in principle does not lack funding for the development of the management system for public finances. The areas covered by this assessment have been the subject of activities of the World Bank, the International Monetary Fund, the European Commission, and other technical assistance providers. The development of the PEM system is also one of the priority areas within component I (institution-building) of the Instrument for Pre-Accession Assistance (IPA). However, in order to establish a sustainable PEM environment, there is a need for further development of the PEM system in other budget-users than the Ministry of Finance.