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Thematic research report

„REFORM OF GOVERNMENTAL ACCOUNTING AND PUBLIC FINANCE“

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I. Introduction

Reforms of the public sector in Croatia are overwhelming and under strong pressure of the accession process to the EU membership. Such fast pace of the reforms presents significant effort for the Government and Ministries. In certain areas there is a strong opposition to the reforms especially when it comes to reduction of government spending related to previously given rights and benefits to the certain groups. Economic crisis that had dramatic spillover effects on the Croatian economy has only intensified the problems and made reform more difficult to pursue and implement.

There are numerous fields of reform under the framework of strategic documents such as the Strategic Development Framework for 2006-2013, the Government Programmes Strategy 2010-2012, the Economic and Fiscal Policy Guidelines and the Pre-accession Economic Programme (PEP). These documents define key area of the reforms. These are primarily in the area of expenditure allocation, taxation, system of internal financial controls and system of government accounting. One of the major tools for accomplishing these goals was certainly the new Budget Act that enables adoption and implementation of more efficient public finance system.

In regards to that, in this phase of the Project, two main areas of reforms are elaborated. Within the part of the reforms of the public sector in Croatia some major categories of these reforms are elaborates, especially the new budget act, structural reforms and improvements of the efficiency of the public administration. Special chapter is devoted to the process of tax harmonization with the EU which is in its advanced phase. The new Budget Act provided the basis for the improvement of public internal financial control and the system of governmental accounting as well.

II. Reforming the Public Sector in Croatia

2.1. Public finance reform

2.1.1. The general context of the reforms


Even though there is a pronounced criticism on the size of the public sector in the Republic Croatia, when compared to other EU countries, it can be observed that Croatia is bellow the average (figure 1). Nevertheless, the goal of the Government of the Republic of Croatia is to reduce its size. In addition, the medium-term economic and fiscal policy goals stated in the Economic and Fiscal Policy guidelines for the period 2010-2012 are as follows: to preserve macroeconomic stability; optimum environment for the development of competitive economy; strengthening the state of law and the rule of law; promoting knowledge, excellence
and culture; uniform regional development; strengthening social equality; positioning Croatia as one of the leading European tourist destinations; more competitive sector of agriculture, food industry and fisheries; further strengthening of the international status; improving the police and armed forces; improving and maintaining health care system; environmental protection and spatial development.

Figure 1: Expenditures of consolidated general government of the Republic of Croatia and EU member states

![Expenditures of consolidated general government of the Republic of Croatia and EU member states](image)

Source: Ministry of finance, EUROSTAT

However, all of these activities are now under the question. At the end of the 2008, the effects of world economic crises started to show their symptoms on the Croatian economy. As it can be seen at the figure 2, growth rate was close to zero in the last quarter of 2008 and then; at the beginning of the 2009 there was a sharp fall. The main channels of transmission of the negative effects of the crisis to the domestic economy were a fall in foreign demand for Croatian exports, changes in investor risk perception and the resulting worsening of the conditions on global financial markets and deepening pessimism in terms of economic expectations. Such dynamics was alarming for the Ministry of finance since these tendencies were immediately translated to the dramatic drop of government revenues especially through the decrease of VAT revenues. This shift of economic and fiscal circumstances made a case for engaging in the public sector reforms in faster pace. However, the problem is that crisis times do not provide enough time for careful planning and analytically based decisions. Reforms will potentially be based on ad hoc decisions which might be harmful for the efficiency of public sector and economy at whole.

Figure 2: Growth rates of Croatian economy
Due to its sound institutional and legislative framework, the Republic of Croatia endured the first wave of negative impacts of the global financial crisis rather well but its later spill-over to the real sector led to lower collection of budget revenue. Therefore, the Government took a series of measures in 2009, aiming at fighting the effects of the crisis and ensuring the stability of public finances. A package of 10 anti-recession measures was adopted in February 2009, as well as three budget revisions, adjusting both the revenue and the expenditure side of the budget.

2.1.2. The new Budget Act

In late 2007, the Government of the Republic of Croatia adopted the State Treasury Development and Modernisation Strategy for the period 2007 – 2011. The goal of the Strategy is to improve and enhance the public finance management system at several levels:

1. At the state level, the aim is to provide the overall fiscal discipline that is the basis for macroeconomic stability. This task, among other things, requires the preparation of the multiyear budget framework to achieve sustainability of the existing programmes and public debt policy.

2. At the level of sectors (the level of ministries), efforts are made to provide for an effective allocation of funds among the sectors, meaning the allocation of resources that is in line with the strategic priorities of the state. The “top to bottom” approach to budget planning and the development of multiyear budget framework are the basis for institutional solutions and the tools for the strengthening of strategic allocation of resources.

3. At the programming/managing level efforts are made to harmonise budget allocations and implementation efficiency which calls for balance between flexibility in budget execution and budget constraints. Implementation measures for this aim should be directed to the strengthening of fiscal control, improving the allocation of funds between
sectors, and ensuring greater flexibility for efficient management and development of the performance accountability system.

The Strategy defines the measures for achieving these goals, with special focus being placed on the implementation of the multiyear budget framework, strategic planning process, redefining of programmes, programme monitoring and evaluation procedures, and performance indicators.

Budgetary system and budgetary relations in the public sector was regulated by the Budget Act of 2003 (Official Gazette no. 96/03.). The law, for the most part, achieved its original goals set, including the establishment of fiscal discipline as one of the most important. However, the development of efficient and sustainable management of public finances requires an institutional framework that will ensure the fiscal discipline necessary for macroeconomic stability. Such framework has to be focused on ensuring the strategic asset allocation and more efficient delivery of public services.

In the former system there was a lack of flexibility in managing the budgets of line ministries and other government bodies, as part of the planning and execution of the budget. The primary objective was to establish fiscal discipline, and now the emphasis is on strengthening and maintenance. This view is supported by the existence of a large number of control inputs and access to "bottom up" decision making on budget allocations. Retention of such a system with a simultaneous tendency to develop a planning budget for the programs would lead to inefficiencies in the system. Lack of managerial flexibility in the public sector prevents long-term efforts to introduce a system based on performance and increasing accountability of public management.

Budget Act amendments were envisaged by the National Programme of Croatian accession to the European Union in 2007. It is obvious that the need for adoption of the new Budget Act was significantly related to negotiations with the European Union. This refers to part of the negotiations in Chapter 22 (Regional policy and coordination of structural instruments) that requires the possibility of several years of planning, transfer of funds for capital projects from one fiscal year to another, greater flexibility in budget execution etc.

Although the Act of 2003. was produced on modern principles of planning the programs, accounting harmonized with international accounting standards and measures to ensure macroeconomic stability, there was a lack of practical implementation of the provisions and clearer and more specific set of rules relationships, rights and responsibilities between national and local institutions and functions in the system budget.

These reform steps in public finances management also required amendments to the legislative framework. The new Budget Act was passed in the middle of 2008 and entered into force on 1 January 2009. The Act introduced:

- Strategic planning and the obligation to draw up the three-year strategy of the Government programmes so that the strategic priorities and Government policy goals could have a direct impact on the allocation of funds within the budget;
- Multiyear budget framework, as the Croatian Parliament will now apart from the budget for one fiscal year pass projections for the following two years;
- Higher flexibility of execution of the budget because the state budget will be passed in less detail, thus rendering the budget easier to survey;
• The possibility to transfer the activities and projects that are financed under the EU pre-accession assistance programmes, and capital projects in the case where they have not been executed by the end of the current year, to the following budget year;
• Including approval which the units of local and regional self-government issue to the institutions and legal persons in their ownership (whether newly established or operating at a loss) in the scope of possible borrowing of the local unit, and the obligation to obtain approval of the minister of finance before issuing guarantees security to the institutions and legal persons owned by the local units, thus ensuring prior control over the issue of guarantees.

In accordance with the provision of the new Act, the Government of the Republic of Croatia adopted a Government Programmes Strategy 2010-2012 in September 2009, which was prepared on the basis of strategic plans of ministries and other government administration bodies. Strategic plans were drawn up on the basis of existing strategic documents and plans, taking into account the set objectives and changes in the environment.

The 2010-2012 Strategy clearly defines goals and priorities to be implemented by the programmes of the Government of the Republic of Croatia within the set time limit. Strategic plans provide an overview of sectoral goals and the Government Programmes Strategy ensures the allocation of budgetary funds to goals which will achieve the greatest impact in priority areas.

In the forthcoming three-year period, measures aimed a development of budgetary processes defined under the Strategy for Improvement and Modernisation of the Processes within the State Treasury will continue. They are:

• development of success indicators, which will contribute to the establishment of the system of responsibility for results achieved,
• establishing an automated system of supervision over liabilities incurrence, including multiyear liabilities,
• establishing a comprehensive accounting system, integrating the main ledgers of budgetary users with the main ledger of the State Treasury in order to ensure the availability of data on the liabilities incurred and their maturity,
• pressing ahead with internal audit of the State Treasury system/business processes according to risk assessment, management requirements and results of risk assessment in the Treasury. In addition, during the same period the area of expert evaluation and assessment of the justifiability and efficiency of investment projects financed by budgetary users will be regulated by a Government Regulation.

The purpose of the Regulation is to improve the management of investment projects by budgetary users:

• by taking more efficient decisions on investment priorities,
• by enabling the development of assessment of investment proposal and managing the costs
• of approved projects in order to improve the value-for-money ratio,
• by providing high-quality information on completed projects to use the gained experience in the preparation and implementation of future projects.
As a result, projects will be chosen that contribute the most to achieving the priority objectives of the Government at the lowest cost, while on the other hand, the notification system will enable all interested parties to monitor project progress and enable the Ministry of Finance plan for funds in the state budget more realistically.

2.1.3. Structural reforms

2.1.3.1. Competition policy and state aid

The main task of competition law and policy is to prevent and prohibit market conduct restricting competition, weather by entering into prohibited agreements, abuse of dominant position or through mergers and acquisitions that can have negative impact on the market. Although the Croatian Competition Agency has been very active, intervening, in the course of 2009, on several markets to prevent the actions that are contrary to the competition rules (telecommunications, gas distribution, sale of refined petroleum products, provision of airport services, etc.), not all the conditions are present yet for development of the effective competition system in the Republic of Croatia, in view of the Agency’s limited competence (it is not competent for the banking sector) and a lack of power to impose sanctions for violating the law.

However, in practice, the activities of the Croatian Competition Agency have not been successful. Therefore, for the purpose of improving efficiency of the Agency’s operation and enhancing effectiveness of the competition system, it was necessary to adopt a new legislative framework for market competition, which would eliminate the previously mentioned deficiencies of the existing one, providing the Agency with the required instruments for the application of competition regulation (e.g. introduction of the so-called leniency programme to fight cartels). The new Competition Act was adopted in the Croatian Parliament at the end of June 2009 and its application starts in 2010. Accordingly, the new Competition Act will strengthen the role of competition law in the Croatian legal system and enhance the role of the Agency by increasing its authority in detecting and then punishing the offenders adequately, promoting thus competition law and policy, especially when providing opinion regarding the compliance of the new and existing legislation with the competition legislation (competition advocacy).

The establishment of the state aid control system represents another important instrument for creating the conditions for the development of effective competition. The state aid control system in Croatia is fully aligned with *acquis communautaire* and the Croatian Competition Agency is authorised to perform control of state aid grants and repayments. Accordingly, in the past several years, the system of granting state aid was established, based on aid schemes, whereas individual aid is granted in increasingly smaller number of cases, as an exception, and predominantly in the case of restructuring of entrepreneurs facing difficulties or as a remuneration for providing services of general economic interest. In addition, all aid schemes, including those based on awarding tax exemptions for new investments, in free zones, as well as in the areas of special state concern and hilly and mountainous areas, are fully aligned with the aid regulations, the application of which began in 2009. Activities are also underway focused on restructuring the shipbuilding sector, through shipyard privatisation, with an aim of abandoning the present method of allocating aid to this sector, and creating the conditions for establishing economic and market sustainability of that sector. In addition, changes in the
aid system for Croatian Radio and Television are being prepared, which will, without prejudice to the role of that institution as a public service provider in realising democratic, social and cultural needs of the Croatian citizens, align the existing legislation governing this field with the state aid regulations.

2.1.3.2. Privatisation

In mid-September 2009, the Croatian Privatisation Fund (CPF) portfolio encompassed 783 companies (736 companies available for sale) with total equity capital of HRK 59.8 billion, out of which HRK 16.5 billion is in state ownership. Although 86 companies were privatised last year (4th quarter of 2008 and first three quarters of 2009) (3 companies by a sale through a public tender, 35 on the Zagreb Stock Exchange and 48 companies were deleted from the court register following a completion of bankruptcy or winding-up proceedings), the portfolio structure by the number of companies and ownership shares has remained almost unchanged compared to the previous year, so that CPF is a minority owner with up to 25% share in equity capital in 80% of the companies (627 companies), in another 72 companies the share ranges between 25% and 50%, whereas in 84 companies the state is still a majority owner with more than 50% share in capital.

In addition to the existing share portfolio structure, where companies facing operational difficulties are predominant and, as such, unattractive to investors, the global economic crisis also had a significant influence on the achieved privatisation dynamics, resulting in a decreased interest of potential investors in investments in the entire region. Consequently, regardless of a large number of invited public tenders (24 tenders were invited for sale of 15 companies, out of which 9 companies were from the CPF portfolio and the remaining 6 related to Croatian Railways subsidiaries), only three companies were privatised. By inviting a tender for privatisation of five shipyards and one subsidiary in majority state ownership, the activities started to resolve the issue of long-term sustainability of the shipbuilding sector which is, from the aspect of privatisation, the most complex and demanding sector that has remained in the CPF portfolio.

2.1.3.3. Support to small and medium-size enterprises

There are several directions of government intervention towards support to small and medium-size enterprises. One of those is the service of the Government of the Republic of Croatia for a quicker communication between entrepreneurs and citizens with state administration bodies – HITRO.HR, commemorates its fourth anniversary. By using services of 61 HITRO.HR offices more than 30,000 companies and crafts were established. Out of a total number of newly-established companies, more than 2,000 were in foreign ownership.

The integrated implementation of the Programme of Incentives to Small and Medium-Size Enterprises 2008 – 2012 of the Government of the Republic of Croatia has been in progress since 18 April 2008. In strengthening competitive capacity of small and medium-size enterprises, a significant progress has been made by the established programme guidelines in
the mid-term period 2008 – 2012, based on the target allocation of resources through various types of incentives.

The measures for promoting competitiveness through networking in entrepreneurship have been implemented on an on-going basis and preparation of the Cluster Development Strategy is underway and is planned to be completed in 2010. In order to expedite and increase women’s involvement in entrepreneurship (female unemployment exceeded 60% of total unemployment), the Strategy for Women’s Entrepreneurship Development 2010 – 2013 will be adopted at the beginning of 2010, which will be followed by drafting of the action plan. Investments in development of entrepreneurial zones in units of local self-government will continue, as well as aid for operation and strengthening of developmental agencies, entrepreneurial centres and incubators and technological parks. The so-called soft incentives will be provided in a form of co-financing of promotional activities as regards operation of small enterprise associations, Croatia’s participation in internationally important projects, management of the existing public e-services and keeping the State Aid Registry. The public-private dialogue forum established in 2008 will meet on a continuous basis, in accordance with the adopted objectives and activities. Favourable financing, including interest subsidies, in the conditions of reduced credits to small business will demand additional adjustments of the annual Operational Plans for Incentives to Small and Medium-size Enterprises.

In the area of training for entrepreneurship, with an aim of enhancing competitiveness, projects are being implemented which promote entrepreneurship through life-long learning. The South-East European Regional Centre for Development of Entrepreneurial Competencies was established, which is a result of a years-long successful implementation of the EU principles of the Charter for Small Enterprises, regulating small and medium-size enterprises policies in the group of south-east European countries. Croatia is entrusted with the role of establishing an independent institution for the development of entrepreneurial competencies, in view of its leading position in the implementation of the principles of small and medium-size enterprises development.

Broadband internet should be developed more intensely, since its inadequacy is already considered by the ICT entrepreneurs, who are exporters of IT and internet solutions, as an obstacle for spreading the business in and outside the region. By the Strategy for Broadband Internet Access Development, the Republic of Croatia fulfilled its primary objective – 500,000 users by the end of 2008. Accordingly, at the end of 2008, there were 683,207 broadband internet users in Croatia. The total density of broadband connections thus accounts for 15.39%. In 2009, the implementation of that Strategy will be assessed and a new strategic framework will be prepared, which will allow for further development of the broadband internet access and improvement of the overall competitiveness of the Croatian information society.

2.1.3.4. Public-private partnership

The Government of the Republic of Croatia, upon the proposal of the Agency for Public Private Partnerships adopted four regulations on 7 May 2009: Regulation on the criteria for assessment and approval of the public private partnership projects, Regulation on the content of public private partnership contracts, Regulation on the supervision of implementation of the public private partnership projects and the Regulation on training of participants in procedures for the preparation and implementation of public private partnership projects. In addition, for the purpose of more efficient and higher-quality proposals and implementations
of the public private partnership projects, on 22 July 2009, the Public Private Partnership Guide was published. The Guide is primarily intended for public sector and it contains instructions for potential contracting authorities for high quality preparation and successful implementation of the PPP projects, in accordance with the Act on Public Private Partnerships, Concessions Act and Public Procurement Act.

The implementing acts, the Regulation on the criteria for assessment and approval of the public private partnership projects, Regulation on the supervision of implementation of the public private partnership projects and Regulation on the content of public private partnership contracts, apart from prescribing the criteria for assessing, establishing and implementing the PPP projects and the adequate preparation and supervision of implementation of the PPP projects, envisage the central management of the PPP projects approval process by the Agency for PPP in co-operation with the Ministry of Finance. Consequently, sustainable and positive projects, in fiscal terms, are being developed, which ensure a long-term value for money and protection of rights and interests of public partners, as well as attraction of new investments. Compliance of PPP projects with positive regulations, budget projections and plans and sectoral developmental plans and strategies of the Agency for PPP and the Ministry of Finance provides evidence to investors of the project quality, which improves safety and sustainability of their investments.

By the end of 2010, the adoption of the Ordinance on establishing and keeping the register of public private partnership contracts is expected, on the basis of which the procedure of establishing the Register will be carried out, which will be followed by the entry into Register of all the PPP contracts, including those concluded before the entry into force of the Act on Public Private Partnership and for which it has been assessed that they have PPP characteristics. Further education, primarily for the Agency employees, will be provided, in the mid-term period, through the project under the IPA 2007 programme, the implementation of which started on 24 November 2009. In addition, for the purpose of strengthening administrative capacity of the Agency, carrying out of training programmes and other forms of employee training is planned. The final goal of these measures is to improve quality of public infrastructure and public services by combining resources, efforts and the know-how of both private and public sectors.

2.1.3.5. Social security system

In the course of preparation and adoption of the Act on Employment Mediation and Unemployment Rights in 2008, it was justified to link the amount of financial compensation for unemployment to the level of previously earned employees’ salaries, taking into account fiscal capacity of the state budget and a multi-year trend of a continuous decrease in the rate and number of the unemployed, i.e. the number of financial compensation beneficiaries. Accordingly, for the first three months the maximum amount of financial compensation amounted to 70% of the previous gross salary after deduction of contributions; for the remaining period until one year it amounted to 50%, whereas the permanent compensation until beginning of employment or pension amounted to 40%. On the other hand, the same Act determined the maximum amount of unemployment compensation relative to the average salary paid in the Republic of Croatia in the previous year (HRK 5,178 in 2008), i.e. any unemployed person that entered the records with the above-average salary was entitled to a compensation relative to the average, rather than his/her own salary. Accordingly, the maximum amount of financial compensation amounted to 70% (HRK 3,625) for the first three
months, 50% (HRK 2,589) for the remaining period until one year, whereas the permanent compensation until beginning of employment or pension amounted to 40% (HRK 2,071).

However, as a result of the effects of the global crisis on the economy and labour market in the Republic of Croatia, the number of beneficiaries of financial compensation for unemployment increased significantly. In June 2009, the number of compensation beneficiaries in the records of the Croatian Employment Service rose by 22.4% compared to the same month in the previous year.

For the purpose of maintaining the fiscally sustainable existential and socially acceptable minimum, the Act on Amendments to the Act on Employment Mediation and Unemployment Rights was adopted in July 2009, which linked the maximum amount of financial compensation to the movements in the amount of the prescribed minimum salary (about HRK 2,252), reflecting the previously mentioned socially acceptable and fiscally sustainable standard. By the application of these amendments to the Act, the maximum amount of financial compensation for the first three months now amounts to 100% of the prescribed minimum salary after deduction of contributions (HRK 2,251), 80% or HRK 1,801 for the remaining period until one year, whereas permanent compensation until beginning of employment or pension amounts to 60% or HRK 1,350. Due to those amendments by the end of 2009 budgetary savings in the amount of around HRK 15 million were realised, whereas in 2010 those savings will amount to HRK 30 million and will be directed at the employment incentives.

In the field of compulsory pension insurance based on generation solidarity (I pillar), since the beginning of the pension reform, i.e. 1 January 1999, the level of pension has been monitored on an ongoing basis and especially the level of early retirement pension, disability pension due to professional incapacity for work in the course of beneficiary’s employment and minimum pension, which were raised for the purpose of improving the financial and social security of their beneficiaries, starting from 1 January 2008, by the Amendments to the Pension Insurance Act. As of the date of application of the aforementioned Act, as well as the Act on the Supplement to a Pension Earned under the Pension Insurance Act, no significant increase in the share of pension expenditures in GDP has been observed relative to the previous period. More specifically, in 2008, the share of pension expenditure in GDP rose mildly to 9.8% from 9.7% recorded in 2007. The fiscal impact of the aforementioned acts is subject to a continuous monitoring, in order to intervene, in a timely manner, in case of a possible growth in the share of pension expenditures in GDP above the anticipated increase in costs of the application of the aforementioned acts of approximately 0.35% - 0.4% of GDP annually.

In compulsory pension insurance based on generation solidarity a further financial consolidation is expected, i.e. a systematic improvement of financial position of the future pension beneficiaries, for whom, since 2009, pension is computed taking into account salaries earned in the entire period of working life, which stimulates prolonged work and exercising of pension rights at a later stage. A moderate increase in pension beneficiaries with a completed qualifying period of 40 years or more in the total number of pensioners has already been recorded, from 10.9% in 2006 to 11.5% in 2008.

In view of unfavourable demographic movements, possibilities are being considered for providing equal conditions for acquiring rights to old-age pension and early retirement
pension for both men and women, and for increasing the age limit for entitlement to old-age pension.

For the purpose of enhancing compulsory pension insurance based on capitalised savings (II pillar), i.e. ensuring adequate pensions for the future generation of pensioners, collection of the relevant indicators is underway to create an analytical basis for considering possibilities within the pension insurance second pillar. Since personal accounts management and capital market investments create high administrative costs, it should be noted that for the purpose of more rational operation of institutions, a centralised collection of contributions and unified administration of personal accounts in the second pillar are prescribed, as well as joining a pension fund in the offices of the Central Registry of Insured Persons (REGOS), which reduces operating costs of pension fund management companies, especially marketing costs, and ensures a reliable inflow of members and contributions.

As regards voluntary pension insurance based on capitalised savings (III pillar), despite unfavourable economic conditions, both in Croatia and in the world, increased interest in participation in that form of additional source of income of citizens in the future has been recorded (6 open-end voluntary pension funds and 15 closed-end voluntary pension funds). Efforts will be made to find the appropriate solutions for promoting the participation in that form of pension insurance.

2.1.4. Public administration reform

The public administration reform continued in 2009. The Ministry of Public Administration that was established in July 2009 is *inter alia* responsible for steering reforms and the modernisation process in the public administration, thus ensuring the preconditions for strengthening of management and administrative capacities of the body responsible for public administration reform.

The new General Administrative Procedure Act was adopted in March 2009, entering into force on 1 January 2010.

Within the framework of the implementation of the new Administrative Inspection Act thorough inspection has been carried out on an ongoing basis. In addition, the organisational structure of the administrative inspection has been strengthened through the establishment of a separate organisation within the Ministry of Public Administration.

At the end of December 2009 the Government of the Republic of Croatia adopted the Civil service human resources development strategy 2009 - 2012. The Strategy was prepared in cooperation of the Ministry of Public Administration and experts engaged in the project ‘Support to Development of the Civil Service Human Resources Development Strategy’ within the framework of Danish bilateral assistance. The Strategy presents the current situation related to human resources, general and specific objectives, means and indicators of its implementation.

By adopting the Strategy for development of electronic administration in the period 2009-2012 and the plan of activities in 2009 and 2010 by the Government at its session held in January 2009 additional incentive was provided to the strengthening of the implementation of the appropriate information and communication technology (ICT) in supporting business
processes and rationalising the operation of the state administration. In the course of 2009, the maintenance and further development of the central web portal of the public administration "My Administration" as well as the computer and communication network ‘HITRO-net’ continued and activities planned for 2009 were carried out. Project tasks have been completed, aiming at the creation of an interoperability framework, as well as the paperless office model (e-Office), the model of a central system for authorisation and authentication and the project for managing knowledge, projects and resources of ICT in state administration.

In the forthcoming period special attention will be given to the regulation of the system of salaries in the public sector and to training as regards the implementation of the new General Administrative Procedure Act.

In the area of application of ICT in state administration there are, at present, no proscribed norms, standards or frameworks to be adhered to by projects or services based on ICT. On one hand, this enables rational management of budgetary funds earmarked for investments in ICT, while on the other it spurs the creation of unconnected IT islands and additional administrative hurdles in the provision of public services.

By the implementation of e-Administration Development Strategy in 2010 it is intended to solve the issue of mentioned imperfections by developing specific models which will, each in its own segment, enable the improvement of state administration efficiency. The final objective is to strengthen the use of ICT in state administration and its communication with Croatian citizens and the economy.

For the purpose of achieving the said objectives, the following measures are planned to be undertaken:
- Alignment of procedural law with the new General Administrative Procedure Act;
- Application of a human resources development strategy;
- Adjustment of the system of public agencies in accordance with the EU standards;
- Regulation of salaries in the public sector;
- Establishment of IT supported central register of civil servants;
- Analysis of the performance of local self-government units and the existing territorial organisation;
- Implementation of activities envisaged under the Implementing plan of the e-Administration Development Strategy 2009-2012 planned for 2010;
- Preparation of the first annual report on the implementation of the e-Administration Development Strategy 2009-2012 for 2009;
- Preparation of a semi-annual report on the implementation of the e-Administration Development Strategy 2009-2012.

The alignment of procedural law with the new General Administrative Procedure Act will ensure consistency and simplify administrative procedures, facilitate exercising of citizens’ rights and reduce procedure costs. Further development of human resources, strengthening of responsibility, ethics, competences and motivation of civil servants in the provision of public services, regulation of the system of public agencies, and development of a more efficient system of local self-government will ensure further strengthening of the efficiency of public administration and reduce operating costs.

2.1.5. Public debt
Starting from 2004, successful fiscal consolidation has been an important characteristic of the fiscal policy of the Republic of Croatia. This, together with the implementation of structural reforms of public finances and the improvement of the budgetary process, set the foundations for resilience of public finances. The deficit recorded lower levels year after year, decreasing by 0.5 percentage points in the period 2005-2007. In 2008, it continued reducing, declining by 1.1 percentage points to 1.4% of GDP.

The process of fiscal consolidation enabled the level of net lending/borrowing to be significantly reduced in the period since 2004 which resulted in positive impact on the movements of public debt as a share of GDP. Consequently, the share of public debt in GDP in 2006 was reduced by 2.6 percentage points in comparison with the preceding year. In 2007, it came to a further decrease of the share by 2.6 percentage points, while in 2008 public debt stood at 29.1% of GDP (figure 3).

As regards the movements in the foreign and domestic components of public debt, it came to the increase in the domestic component of public debt in the past several years, i.e. to the reduction in the foreign component of public debt. In the period 2004-2008, the foreign component of public debt continually declined from 54.1% in 2004 to 30.4% in 2008. The domestic component went up continually from 45.9% in 2004 to 69.6% in 2008. These developments resulted from the orientation to mostly domestic sources for the purpose of financing the general government deficit.

**Figure 3: Public debt of the Republic of Croatia**

The majority of the public debt is associated primarily with borrowing through securities, followed by loan borrowings. The period 2004-2008 was characterised by the Government's orientation towards securing financing through issues in the domestic market, which reduced the dependence on international capital markets. It has also had a positive impact on external debt developments and has contributed to the development of the domestic financial market.

At the end of 2008, the largest share of public debt was related to the budgetary central government (93.3%), followed by the debt of extra-budgetary users (4.8%) and local
government (1.9%). In terms of the currency structure, it is noteworthy that about 4/5 of the debt is denominated in foreign currency, mostly in Euros.

Taking into account the changes in financial markets, including the domestic market, and maturing foreign liabilities, a share of 2009 financing needs was met by issuing a foreign bond in May 2009, when, after five years, the Republic of Croatia returned to the foreign financial market to issue a Eurobond worth EUR 750 million at the price of 99.675% of the nominal amount, fixed annual rate of 6.5% and maturity in 2015. In November 2009, the second bond was issued in the US financial market, worth USD 1.5 billion, at the fixed rate of 6.75% and 10-year maturity. As a result of the abovementioned changes in financial conditions and changes in domestic and global macroeconomic conditions, a share of 2009 total financing needs was meet through short-term instruments, primarily syndicated loans of domestic banks and T-bills.

The general government deficit and due liabilities movements in the forthcoming three-year period will result in higher financing needs relative to the historical average, which will reflect itself in the share of public debt in GDP. Consequently, the share of public debt in GDP will rise in the forthcoming period from the estimated level of 33.5% of GDP in 2009 to over 37% of GDP at the end of the period under review, tending to stagnate in the last year. In addition, it will come to certain changes in the levels of the foreign and domestic component of public debt expressed as a share of GDP in consequent of maturing liabilities in the period under review and the planned new borrowing both in the domestic and the foreign financial market.

| Table 1: Projection of consolidated general government public debt and deficit |
|-----------------|---------|--------|--------|--------|--------|
|                 | % of GDP| 2008   | 2009 p | 2010 p | 2011 p |
| Public debt     |         | 29.1   | 33.5   | 36.1   | 37.3   | 37.4   |
| Foreign         |         | 8.8    | 10.5   | 13.2   | 14.1   | 15.8   |
| Domestic        |         | 20.2   | 22.9   | 22.9   | 23.2   | 21.6   |

Source: Ministry of Finance

Moreover, aiming at creating additional room for the financing of the private sector in the domestic financial market, the Government issued a Eurobond after being absent from foreign financial markets for five years. The first issue was in May, worth EUR 750 million and maturing in 2015, while the second issue was in November, worth USD 1.5 billion and with a 10-year maturity. These measures contributed to the stability of public finances in 2009 in the circumstances of an economic crisis and created a starting point for implementation of the fiscal policy in the forthcoming three-year period, aiming at ensuring system liquidity and creating the preconditions for economic recovery.

2.1.6. Local government finance

The reform of the territorial and administrative organization of the public sector in Croatia started in 1994. By the Constitution, Croatia was proclaimed as a federal state consisting of three tiers of government – the central government; regional government - 20 Counties plus the special area of the City of Zagreb (which has the status of City and County) and the local government sector (which consists of cities and municipalities). Such concept of territorial division had intention to set up counties as classical regions with the function of a middle tier
of government. It is very important to address this spatial setup at the beginning because it had crucial impact on the results of the decentralization process.

Territorial reform resulted in too large number of counties, cities and municipalities. It was clear from the beginning that decentralization process in circumstances of such fragmentation of governmental space cannot be sustainable. However, in spite of that, from the 1994 the number of cities and municipalities increases. At the moment, there are 576 sub-national governments – 21 county, 128 cities and 427 municipalities. That is the reason why a substantial number of Croatian local governments and cities are quite small. That resulted in fact that many Croatian local governments do not have the appropriate financial, administrative, technical and personnel resources to carry out the basic functions of local governments.

Until 2001 counties had dual functions and were primarily responsible for performing delegated tasks from the central government level. Their role of self-government acting in accomplishing goals of regional provision of public goods and services was seriously neglected. That situation resulted with unclear division of responsibilities. In year 2001 new Law on Local and Regional Self-Government was adopted. By this Law counties are defined as the units of regional self-government.

From the 2001 responsibilities of counties, cities and municipalities are more clearly defined. Counties are responsible for activities of regional importance, such as education, health care, urban planning, economic development, traffic, and transport infrastructure, and for 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. These activities involve housing and community amenities, urban planning, municipal services, child and social care, primary health care, childcare and primary education, culture, physical education, sports, consumer protection, protection and promotion of natural environment, fire fighting and civilian protection. Distribution of responsibilities according to the level of government is provided in the table 2 below.

Table 2: Distribution of responsibilities according to the level of government in Croatia

<table>
<thead>
<tr>
<th></th>
<th>Central government</th>
<th>Counties</th>
<th>Cities</th>
<th>Municipalities</th>
</tr>
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<tbody>
<tr>
<td>General public services</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
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<tr>
<td>Defense</td>
<td>x</td>
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<td></td>
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<tr>
<td>Public order and security</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
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<tr>
<td>Education</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
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<tr>
<td>- preschool</td>
<td></td>
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<tr>
<td>- elementary</td>
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<tr>
<td>- secondary</td>
<td>x</td>
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</tr>
<tr>
<td>- tertiary</td>
<td>x</td>
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<tr>
<td>Health care</td>
<td>x</td>
<td>x</td>
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<tr>
<td>Social security and welfare</td>
<td>x</td>
<td>x</td>
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<tr>
<td>Housing and communal</td>
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Croatia has started an ambitious policy of decentralization since 2001. By this decentralization program, sub-national governments obtained new assignments in the area of elementary and secondary education, health care, welfare and firefighting. Local governments had responsibility for financing of the part of the costs of health care and education (material costs and expenditure for the procurement on non-financial assets) and of total costs of financing welfare and fire departments. However, delivery of these decentralized functions has been taken only by local governments that had highest level of fiscal capacity. Out of their total number, only 53 of them assumed the obligation of financing these functions. In addition, from 2002 the financing of the fire departments was taken on by 83 local government units (municipalities and cities). The uneven financial capacity is clearly visible by the fact that the total budget of the 53 local government units that took over the financing of the decentralized functions constitutes about 70% of the consolidated budget of all local government units (see Bajo, Bronić, 2005).

Legislative changes in 2005 established the concept of “large cities”. 32 cities have that status and they are allowed to take over functions of counties if they are financially and technically capable. Fifty-three local units (20 counties and the city of Zagreb and 32 other cities) accepted the obligation to finance previously mentioned decentralized functions (elementary and secondary education, health care, welfare and firefighting). An additional share in personal income tax and equalization grants funds new responsibilities for these units. The introduction of the large cities can be rationalized as attempt to give more autonomy to the cities that have more capacities to provide higher level of local public service. Until these amendments to the legislation were introduced, small and large cities had same responsibilities which created strong inefficiencies. Small cities were not able to deliver given responsibilities and large cities had an excess of capacity due to the lack of responsibilities delegated to them.

<table>
<thead>
<tr>
<th>economy matters and services</th>
<th>Recreation, culture and religion</th>
<th>Agriculture, forestry, hunting, fishing</th>
<th>Mining, industry, construction</th>
<th>Traffic communications</th>
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<tbody>
<tr>
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Bronić, Bajo (2005, p. 5-6)
Nevertheless, the decentralization process in Croatia is still at its beginning. Since the reform in 2001 and introduction of large cities in 2005 there were no substantial changes in terms of further decentralization. The Central government does not have confidence in the local sector. One of the main reasons for this is territorial-administrative public sector organization. Such a state presents problems for the further delegation of public function to lower levels of government.

In spite of the formal efforts toward a higher level of decentralization, sub-national government budgets still amount around 15% of the total consolidated government revenues. Nevertheless, sub-national governments finance a larger share of government investments. In addition to that, there are great divergences in the fiscal capacity of counties, cities and municipalities. The role of the cities is dominant. The problem is that delegated functions and responsibilities do not follow from the financial capabilities. Counties have a wide responsibility but their fiscal capacity is often much smaller than the capacity of cities within their borders. In addition, about 30% of the budgets of cities and municipalities go to public investment projects. In case of counties, only 17% of the budget is directed towards investment expenditures.

All municipalities and cities may also carry out matters from the self-government jurisdiction of the county in their own area, if they provide funds for the financing of them. Although the responsibilities and jurisdictions of local government units are laid down, nevertheless local government units do not have total fiscal autonomy in the financing of all their expenditures because revenue sharing and central government grants are earmarked for financing decentralized functions and capital investment. Local government units finance a significant part of their expenditures in collaboration with central government, which provides grants from the central government (national) budget via the Ministry of Finance or the competent ministries. Greater local government unit autonomy can be found in connection with the performance of the communal economy activity, preschool education and cultural, sporting and religious activities (Bajo, Bronić, 2005, p. 6).

In table 3 tax assignment in Croatia is presented. Own taxes given to the county level are by their nature of minor significance. In terms of overall revenue collection, there are three major tax sources. That is Value added tax, Corporate income tax and Personal income tax. The main source of revenue for sub-national government level is Personal income tax, which is distributed by the sharing mechanism. However, counties receive only 15% of the total Personal income tax distributed. In spite of that minor share, revenues from the Personal income tax take 93% of the total tax revenues and 80% of the total revenues of the County budgets. Personal income tax is the main source of revenue for the cities as well. Due to the fact that this tax is not directly related to local government expenditures there is a clear issue of lack of accountability in terms of local spending. Citizens do not perceive relation between revenue collection and local spending and therefore there is no pressure on increasing the local government accountability. The only real and significant local tax is the surtax on income tax which is piggybacked on the personal income tax. However, it is collected by the central Tax administration office and local governments do not have control on the collection and distribution of this revenue. In addition, it is clear that local governments do not want to raise this surtax due to assumption that such action would be perceived very negatively by the citizens. Instead of that they are more prone to increase non-tax revenues (i.e. communal fees and contributions) which are sort of quasi-tax revenue source. The problem is that these fees are non-transparent both by their mechanism of collection and ways of their utilization. Establishment of property tax would provide grounds for improvement of local government
responsibility and accountability; however, there is still strong resistance towards its introduction.

Table 3: Tax assignment in Croatia

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Tax assignment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government level</td>
<td>- VAT&lt;br&gt;- Corporate income tax&lt;br&gt;- Special Taxes (excises) on cars, motor vehicles, vessels and aircraft; mineral oil, alcohol, beer, non-alcoholic beverages, tobacco, coffee, luxury products, liability and comprehensive road vehicle insurance.&lt;br&gt;- Levy on the organization of games of chance</td>
</tr>
<tr>
<td>Regional (county) level</td>
<td>- Taxes on inheritance and gifts&lt;br&gt;- Motor vehicle licenses&lt;br&gt;- Taxes on other vessels&lt;br&gt;- Levy on coin operated machines for amusement</td>
</tr>
<tr>
<td>Cities and municipalities</td>
<td>- Consumption tax&lt;br&gt;- Taxes on holiday houses&lt;br&gt;- Trade name&lt;br&gt;- Surtax on income tax&lt;br&gt;- Taxes on the use of public land</td>
</tr>
<tr>
<td>Shared taxes</td>
<td>- Personal income tax&lt;br&gt;- Real estate transfer tax</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance – Tax Administration, 2009 (http://www.porezna-uprava.hr/en)

Despite numerous obstacles, it appears as though the situation is improving, however in slow pace. Positive changes are particularly visible in general budget related concerns (regarding classification, consolidation, accounting, and the national treasury system), and also, to a somewhat lesser degree, with respect to expenditure side problems (regarding long-term capital project planning, controlling borrowing, and recording liabilities). Almost no improvements were observed in mitigating problems related to the number and sizes of local government units or the budgetary process (internal controls, audits, and guidelines of the Ministry of Finance) (Ott, Bajo, 2003).

The main problem that curbs the decentralization process in Croatia is territorial and administrative organization. So far, it was considered that reforms towards better setup are not possible due to the lack of political power to pursue such radical changes. However, economic crises inspired wide public debate on necessity of such reform that would reduce increased costs of government bureaucracy and improve the efficiency of the local sector. This fragmentation was the main justification for the central government to stop further delegation of responsibilities towards local governments.

However, there are additional issues that burden the local government efficiency and there was no progress in these areas. Ott and Bajo (2003, p. 13) mention some of these: public investment planning, revenue structure, insufficient shared taxation, position of utility companies, evaluations and rewards for the work of employees, internal controls, audits of joint stock companies owned by local units etc. However, there were improvements in the following areas: division of functions and responsibilities, budget classification, financial equalization and allocation of grants, consolidation of local government units’ budgets,
accounting, plans and estimates of the budget, financial control of the local government units’ borrowing. Nevertheless, it can be concluded that decentralization process in Croatia is stopped and there are no significant improvements except the natural developments up the learning curve of local governments. Higher level of decentralization and step towards increased accountability is possible only after forthcoming territorial-administrative reform.

As it was previously stated local governments in Croatia have little autonomy. It is usually considered that greater autonomy of local governments in terms of revenue collection leads to the realization of smaller deficits particularly in cases where there is a high tax competition. However, these authorities are more sensitive to cyclical movements. Tax reform in 2007 when corporate income tax became central government own tax and higher share of personal income tax was given to local government decreased the likelihood for procyclical effect of corporate income tax. However, in period of expansion revenues from corporate income tax raised much more relative to personal income tax. In period of crises trend is opposite and revenues from corporate income tax fell much more and revenues from personal income tax remained stable which relaxed financial position of local governments. Rate of surtax imposed on personal income tax is potentially most significant tool for influencing the level of local revenues on side of local government. However, local authorities are very sensitive to the possibility of raising that surtax in case of financial problems. The main reason for that is that this tax is highly visible and local governments are more prone to use different non-tax sources of financing.

However, despite of the fact that data show just linear decrease in revenues there are potential problems that come from borrowing and models of the private-public partnerships (PPPs) used in some local units in recent period. Even though fiscal rules in Croatia imposed hard budget constraint by using PPP models there are additional burdens on side of the current budget. Additional problem is that these fiscal rules are not good enough because they are primarily focused on static indicators. For example, the maximum amount of indebtedness of local governments is often determined by budgetary provisions which define the maximum debt ceiling - in Croatia that amounts to 20% of operating revenues. However, the problem occurs because in period of economic expansion there is a possibility of increase of total amount of debt by following the growth of revenues. During the crisis, the amount of the repayments from the previous period remains, and falling revenues might cause liquidity problems. In that case, limit of 20% can be easily breached. When fees based on PPP based contracts are added financial position is even more fragile. The problem is that obligations made by borrowing and PPP fees were not treated similarly by fiscal rules framework even though in economic sense there is no difference. Finally, some local governments engaged in borrowing through their communal enterprises which presents a sort of hidden debt.

The question is also to what extent rigid budgetary constraints limit the possibilities of local government units to undertake fiscally unsustainable activities. In this sense, the effects will depend on the structure of revenues, the possibilities for borrowing (as well as creative accounting) and budget spending that has largely defined by obligations from the previous years.

The problem imposed by the balanced budget rule is that the greater the fiscal risks are the shorter time for budget planning has to be. Such preoccupation with the economic cycle makes budget control and monitoring much harder. Usually measures to reduce costs have been focused on investments which are easiest to hurl in a shorter period. In this way allocative efficiency is reduced. Similar tendency occurs in Croatian local governments.
During the period of boom and high revenues numerous investments were financed either from current revenues or by using short-term debt financing. Such practice created problems for some governments already in the period of expansion. Nowadays, problems are intensified because investment activity is minimized and obligations from the previous period remain and are harder to service. Additional problem is related to the issues of allocative efficiency. In recent period, significant investments were devoted to sports facilities without appropriate planning what created cases of overcapacity of sports facilities. These objects were financed mainly by borrowing or by using models of PPPs and present significant financial burden for numerous local governments in future period.

2.1.7. Public finances and economic crisis

In 2009, the Government took a number of measures aimed at combating the effect of the crisis and maintaining the stability and solvency of the public finances. With regard to further aggravation of macroeconomic conditions, in July 2009 two budget revisions were adopted to ensure stability and sustainability of the budget. In the revision adopted in the middle of July the projected state budget revenue was lower compared to the previous plan by HRK 6.8 billion. HRK 2.2 billion were redistributed within the budget so that additional savings amounting to HRK 780 million were achieved on the expenditure side. It has to be noted that, as part of this budget revision, the salaries of state officials were reduced by further 5% by reducing the salary base compared to the base from April 2009. What is more, the pensions paid under the Act on the Rights and Duties of Members of the Croatian Parliament were reduced by 10%. In addition, the measures granting free transportation for high school students and free textbooks for all pupils were revoked, except for the pupils coming from low-income families.

Together with the budget revision adopted at the end of July 2009, a number of acts were adopted having direct impacts on the revenue and expenditure sides of the budget. The Act on Amendments to Value-Added Tax Act was adopted increasing the general VAT rate from 22% to 23%. The Act on Special Tax on Salaries, Pensions and Other Income was introduced and it will be implemented until 31 December 2010 as a special tax imposed on salaries, pensions and other income exceeding HRK 3,000 (2%), or HRK 6,000 (4%). Adoption of the Act on Amendments to the Act on Excise Duty on Passenger Cars, Other Motor Vehicles, Vessels and Aircraft implemented equal criteria for the taxation of vessels and aircraft with passenger cars and motorcycles, and it reinforced taxation according to the economic power.

In the April of 2010 Croatian government launched a Program of economic recovery that consisted of measures that should enable fast pace economic recovery. Interestingly the measures within the program were aimed to eliminating certain long term inefficiencies of the public sector such as illiquidity. It can be observed that program is mainly focused on the fiscal area and is focused both on short-term and long-term based measures. Since crisis in Croatia is mainly based on structural inefficiencies of the economy, current crises just aggravated these problems. Therefore, there was a window of opportunity to pursue with some politically unpopular measures that would, otherwise, in „normal“ time engage with fierce resistance of the interest groups.

There are five key cornerstones of the Program:

1. reduction of public sector spending, together with increase of efficiency and transparency
2. reallocation of budget spending – from irrational spending towards targeted social transfers and economically viable capital investments

3. reduction of government intervention – continuation of the privatization process, creating the professional management within public enterprises and government institutions

4. initiating the new investment cycle with economically measurable long-term effects, with maximum engagement of the private sector

5. hastening the reform implementation: judiciary, health system, pension system, state and local administration.

There are three areas of urgent action – changes in the role of state, support for the recovery and growth and responsibility towards future generations. There are three areas that can be defined as an attempt to change the role of the state. First area is focused on fiscal consolidation with aim of gradual reduction of government deficit under the level of 3% of GDP:

- measures within the tax system – especially through the personal income taxation, changes of tax rates and elimination of all the tax exemptions except those for research and development
- planned reduction of government expenditures
- sale of government shares in enterprises in which government keeps less than 25% of share
- reduction, i.e. elimination of numerous non-tax revenues sources and central government recommendations to local governments in regards to such reductions
- analysis of efficiency of horizontal government subsidies
- reduction of additional payments to the public sector employees and their directions towards the unemployment subsidy and social security schemes.

Second area of reforms are focused on rationalization of the system of government administration and raising the efficiency of provision of public services. Some of the measures to achieve such goal are creation of registry of public sector employees, centralized system of public procurement, decentralization of state institutions and agencies, increase of the mobility of public employees, territorial-administrative reform towards smaller number of local government units and many others.

Finally, the third pillar is related to the managing of government assets. There is a need for more rational management and further privatization of public sector enterprises.

There are also numerous other measures that address direct government intervention into the economy. One of the most ambitious measures was to eliminate illiquidity caused by government unpaid obligations. However, this measure so far was proved to be too ambitious and government postponed the deadline for this goal.

II.2. Tax system reform

2.2.1. Introduction
Croatian tax reform started in 1994 when new consumption-based corporate and personal income tax as well as most excise duties were introduced. The following introduction of VAT in 1998 was the first major step towards the EU. The bulk of reform changes were connected with the EU accession, especially concerning VAT and excise duties.

The first chapter briefly states tax burden tendencies and describes the structure of Croatian tax system, commenting both in relation to the EU. The second chapter deals with the specific characteristics of Croatian personal and corporate income tax, which had presented the first attempt in the world to apply consumption-based direct taxation. Although such a pioneer attempt was rejected in 2001, the present personal income tax still possesses a lot of elements of consumption-based taxation. Even its newest announced changes bring it closer to that concept. The third chapter is devoted to VAT and especially its major changes which have brought it more into line with the *acquis*, indicating the remaining necessary changes. The same is true for fourth chapter, which deals with excise duties. The last chapter presents basic organizational characteristics of Croatian tax and customs administration, pointing out the organizational changes as well as administrative cooperation and mutual assistance development connected with the EU accession.

2.2.2. Tax burden and tax structure

Similar as in other countries, taxes in Croatia are the most important public revenue. Together with social security contributions they contribute to almost 90% of public revenues of consolidated general government. The development of the entire tax burden (including social security contributions regarded as taxes) over time is presented in Figure 4.¹

Figure 4: Total taxes in GDP in Croatia 1995-2008 (%)

![Graph showing total taxes in GDP in Croatia 1995-2008 (%)](image)

Source: Kesner-Škreb, Kuliš, 2010b, p. 16.

¹ The tax data during the entire period are based on the taxes actually paid and not the taxes due, since Croatia still does not apply accrual accounting for the revenues.
It could be seen that the general downwards trend in tax ratio is presented (according to the contemporary tax policy requirements and development in most Central and Eastern European new Member States of the EU – EU12\(^2\)). This downwards trend was reversed only in 1998 (and 1999) due to the introduction of VAT, when, similar as in most of the EU and future EU countries, tax revenues rose. However, the last years experience the stagnation.

Tax ratio for 2008\(^3\) is below EU, EU 15 as well as OECD average (EC, 2009, p. 251; OECD, 2009, p.19), but a little bit above the EU 12 arithmetic average of 34.3 (author’s calculation, based on EC, 2009, p. 251).

The newest economic recovery programme of Croatian government (Vlada Republike Hrvatske, 2010, p.14) includes the plan for further gradual decline in tax ratio - precisely the share of all revenues in GDP for three percentage points up to 2020.

The Croatian tax structure is presented in Figure 2.

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\(2\) The same trend is not so pronounced in the old EU Member States, where on average the overall tax ratio started to decline after 1999, but rose again after 2004 (European Comission, 2009, p. 33-35 and 251).

\(3\) As already pointed out (footnote 1), this ration is calculated based on tax revenues actually collected (cash accounting). However, it confirms the short run stagnation of the tax ration (cease of the downwards trend).

\(4\) higher then in any new EU member state (EC, 2009, p.257)
2.2.3. Tax reform of (personal and corporate) income taxes: from consumption-based to income-based (and back?)

Croatia was the first country in the world fully to accept the consumption concept in the field personal and corporate income tax\(^7\) in its alternative form - the “interest-adjusted (personal) income tax” and “interest-adjusted corporate income tax (profit tax)” (“ACE tax”)\(^8\).

Advocates of consumption as the appropriate tax base claim that income as a tax base discriminates against saving, which is taxed twice - first as being part of the income that is taxed by income tax and second as capital income that is part of the comprehensive income of the next period.\(^9\) Saving and investment escape this double taxation in consumption-based income and profit taxes, where the METR (marginal effective tax rate) is zero. In Croatia this was achieved in the simplest possible way - by not taxing capital income (interest income in the broader sense) at the individual level\(^10\) and taxing only profits above the “normal” rate of return at the enterprise\(^11\) level, which is technically made by subtracting the so-called “protective interest” (“equity allowance”)\(^12\) from the profit. So, saving and investment neutrality was followed by financial neutrality, because of interest (in the narrower sense\(^13\)), dividends and capital gains being treated in the same way. The neutrality was also reflected in non existence of non-standard tax reliefs at the personal level (with only standard tax reliefs including relief for compulsory social security contributions) and the existence of only two marginal tax rates (almost ”flat tax” concept).

The term “protective interest” implies that it protects the normal return on equity from taxation. It can also be said that it taxes only true “economic profit” and not the whole of accounting profit, leaving the "minimum existence for capital" (acc. to Rose, 1998) exempt.

\(^5\) However, Croatian municipalities levy some sort of user charge for the real estate (communal charge), that is levied not on the value, but size (in \(m^2\)), taking into the consideration also some other elements (purpose, area, different coefficients charged by municipalities).

\(^6\) This is, of course, not due to the rise in corporate income tax rate, but rising economic activity.

\(^7\) Personal income tax is in Croatia called only „income tax“, since corporate income tax is called „profit tax“.

\(^8\) In the field of corporate taxation, Austria and Italy accepted some elements of this model, but abandoned it later. Belgium is the country now applying the model for corporations (thanks to “notional interest”, which was named “protective interest” in Croatia). Non taxation of some capital income in a lot of transition economies is also the element of that model, but does not represent the complete model.

\(^9\) In addition, capital income from the corporate sector (dividends and partly capital gains) is taxed once again because of the corporate income tax.

\(^10\) The Croatian consumption-based tax system still had some “mixed system” characteristics regarding personal expenditure tax elements concerning pensions treatment, and comprehensive income tax elements concerning real estate (except owner-occupied housing), because of the inclusion of rental income as well as real estate capital gains (only short term gains, and not applied to owner occupied housing) in the tax base.

\(^11\) The term “enterprise” comprises here both profit taxpayers and self-employed income taxpayers, because the later had the right to deduct “equity allowance” too.

\(^12\) It was calculated by applying “normal” interest rate (3% and later 5%) defined by the tax law and corrected for the inflation rate to the invested enterprise equity (at the beginning of the year).

\(^13\) Payments connected with debt capital
Since there was no well-developed government bond market in Croatia, which according to the theoretical models (for instance IFS, 1978; Kaiser, 1992…) should determine the rate of such an allowance, this protective interest was first determined by the central bank’s prime rate and later statutorily stated (first it was 3% and later 5%). This 5% exemption led to some sort of progressiveness in the Croatian corporate income tax. Higher profits (above 5% on equity) lead not only to higher tax, but also to a higher average effective tax rate. Since this progression is due only to the indirect progression (5% equity allowance) it logically follows that it slightly diminishes (changes to proportionality) for higher rates of return. Likewise, it is sharper for “lower” rates of return (just a little bit above 5%).

There was also a pressure for more “cash flow” type allowances, which bring immediate and more considerable tax release (up-front allowances), directly favouring new investments only. This was reflected in the accelerated depreciation allowance\(^{14}\) (introduced in 1997), which together with the equity allowance and the relatively low tax rate\(^ {15}\) offered a remarkable tax incentive for investment.

In 2001 the existing system was replaced by a “mostly” income-based system. The “protective interest” (equity allowance) at the business level was abolished\(^ {16}\) and dividends and interests were introduced in the tax base of income tax. Still, the new system retained some consumption-based elements (non taxation of a lot of capital incomes), so it is still some hybrid form between income-based and consumption-based tax. This consumption-based element is increased again in 2005, when dividend taxation was abolished again.

The movement in tax rates and tax reliefs follows the same pattern. In accordance with the consumption-based requirements, there were very limited number of tax reliefs (only “standard” ones) and almost a flat tax structure (only two rates of personal income tax: 25 and 25%). The number of rates/brackets was gradually increased to four (15, 25, 35 and 45%) now and gradually more and more new “non-standard” tax reliefs were introduced. So, the system resembles more to the EU 15 income tax systems now, that unlike some new EU members and candidate countries have more non-standard reliefs and strongly pronounced direct progression. However, the new government economic recovery programme (Vlada Republike Hrvatske, 2010, p. 13) plans to reduce number of tax rates/brackets to three (12, 25 and 40%) lowering the marginal tax rates and to abolish all non-standard tax reliefs (except for research and development), which is in line with tax reform tendencies in EU and OECD and is especially pronounced in the new EU members as well as candidate countries.

At the corporate level, the programme plans to strengthen the role of efficient tax incentives with the special emphasis on research and development, education, environment protection and energy efficiency, which is in line with the EU trends and recommendations. A lot of previous tax incentives not compatible with the fiscal state aid rules were abolished or modified. Some current tax incentives for underdeveloped regions are in the process of

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\(^{14}\) Official straight line rates were allowed to be doubled (depreciation period halved).

\(^{15}\) At the beginning of the reform the rate was only 25%, followed by the 3% equity allowance. In order to avoid distortions, because of the highest personal income tax bracket rate being 35%, the profit rate was raised to the same level, followed by the increase of equity allowance at 5% in order to offset the rise in the nominal profit tax rate.

\(^{16}\) Some of the reasons mentioned were high tax expenditures as well as “non-compatibility” with the EU tax systems. The tax rate was decreased also as to preserve the revenue neutrality as well as the “incentive” effect for taxpayers. Although this decline in tax rate could be seen in the light of “race to the bottom” trend in tax rates in the EU (as well as OECD and world-wide) it was the direct result of the “protective interest” withdrawal.
gradually phasing out. However, modified tax holidays have survived and they are now major tax incentives, together with incentive for research and development and education.

Since dividends received (domestic and foreign) are exempt from corporate income tax and withholding tax on dividends paid to foreign residents abolished in 2005 (together with taxation of dividends inside the domestic personal income tax), Croatia is already more than in line with the EU Parent - Subsidiary Directive. The Merger Directive and the Interest and Royalties Directive are added to the Corporate income tax act (Profit Tax Act) in 2008 and will be effective from the moment of the Croatian accession to the EU\(^\text{17}\).

Exchange of information between member states of the EU concerning interest payments on savings income based on Savings Directive is included in General Tax Act in 2008 as well as administrative cooperation rules based on Directive 77/799 EEC and Directive 2008/55 EC. They also both enter into force at the moment of Croatian accession to the EU.

2.2.4. **Introduction of VAT and its changes: towards the EU**

The introduction of VAT in 1998 was first major step in the movement of tax system towards the EU requirements. Croatian today’s VAT is mostly in accordance with the “VAT Directive” of the EU, but the full compatibility with the *acquis* requires the new VAT act, which will be effective after Croatian accession into the EU. It is scheduled for the end of 2010.

At the moment of the introduction of VAT Croatia had only one (standard) rate of VAT of 22%. Since it was above 15%, it was in accordance with the EU requirements concerning rates. However, after almost two years (November 1999) the zero rate was introduced, which is not in line with the EU harmonization requirements. The zero rate encompassed bread, milk, printed books and textbooks as well as certain medicines and orthopaedic aids. Only one year later (September 2000 and November 2000) books published on other media, scientific journals as well as public showing of films were also included in the scope of zero rate. In 2006 the reduced rate of 10% (above lower EU limit for reduced rates of 5%) was applied to the following tourist services: room only, bed and breakfast, half board or full board accommodation services in all types of the listed commercial catering facilities and agency commission services for all the abovementioned services\(^\text{18}\). In 2007 the reduced rate of 10% was applied for newspapers also. Unfortunately, due to the current recession and resulting budgetary problems, the standard rate of VAT in Croatia was raised to 23% in 2009 (until the end of the 2010). The zero rates will be, of course, abolished at the EU accession and even

\(^{17}\) Also enacted were the new Act on Areas of Special State Concern, and the acts that amended the Act on Hilly and Mountainous Areas, the Act on the Reconstruction and Development of the City of Vukovar, the Act on Free Zones and the Act on State Aid for Education and Training. The tax incentives in special areas (free zones, city of Vukovar, Areas of Special State Concern and Mountainous Areas) are gradually phasing out (for agriculture and fishery they will terminate by the date when Croatia will join EU).

\(^{18}\) It corrected previous distortion and differential treatment of tourist services for foreigners paid from abroad (that were taxed at zero rate) and those one for domestic tourists (that were taxes at full – standard rate of 22%). However, the uniform VAT rate of 10% for the tourism sector is not in line with the *acquis* (http://europa.eu/legislation_summaries/enlargement/ongoing_enlargement/community_acquis_croatia/e10114_en.htm; Izvješće o analitičkom pregledu (Screening) Hrvatska, Poglavlje 16, p.11). It is planned to abolish the reduced rate for half board and full board services (Hrvatski Sabor, Nacionalni odbor, 2010, p.7).
transitional regime will not be used. So, Croatia, unlike other new EU members, will not continue to apply zero rate for a couple of years after its accession to the EU. The zero rate is planned to be replaced by the reduced rate.

Already at the introduction of VAT the exemptions encompassed the main ones as in the EU, but where not so exhaustive. Inside the group of the exemptions in the public interest the most important exception included postal services and public radio and TV. After the new VAT Act (from 2009; that came into force on January 1st 2010) all the “missing” activities (exceptions) were added to the list of tax exempt activities in the public interest, including also postal services and public radio and TV. Similar was with the exemption of other activities, where first only the renting of housing premises, services and deliveries of goods of banks, savings institution and savings and loan organisations, insurance and reinsurance companies were mentioned, and during the later years (before 2010) the organisation of special games of chance in casinos and slot machine clubs, and betting added (with lotteries even later). This is closely connected with the previous used “institutional” principle. Namely, concerning exemptions, the “institutional” principle was first applied in Croatia instead of the “functional” one (applied in EU). Institutions that are engaged in tax exempt activities were exempt from taxation altogether. That was arranged mostly for the simplicity reasons. This caused the distortion in supply of stated services at the market (the supply of the same service was exempt when supplied by the appropriate institution (for instance bank or insurance company) and taxed when supplied by some other supplier. The new changes in VAT Act introduced functional principle from 2010, with the underlying difficulties of not only separating taxable and non-taxable activities, but also deductible and non-deductible VAT paid on inputs.

Other exceptions included the supply of human organs, blood and milk, the supply of services by dental technicians in their professional capacity and the supply of dental prostheses by dentists and dental technicians, the supply of for the purpose of rendering their members the services directly necessary for the exercise of that activity, where those groups merely claim from their members exact reimbursement of their share of the joint expenses, the supply of certain services closely linked to sport or physical education by non-profit-making organisations, the supply of services and goods by organisations whose activities are connected with fund-raising events (the supply of transport services for sick or injured persons in vehicles specially designed for the purpose, by duly authorised bodies was not listed also, but it was not necessary, due to the fact that it was provided in Croatia only by the medical institutions, which were exempt according to the „institutional principle“ – see the further text). For the very exhaustive analysis of compatibility of Croatian VAT with the aquis see also (Javor, 1994).

However, the planned liberalization of financial services in the EU in 2011 (removal of the current exemption from VAT and an option to apply a reduced rate to a wide range of postal services) would imply also future changes in this part of VAT regulation in Croatia.

The supply of certain services closely linked to sport or physical education by non-profit-making organisations is the only remaining exception.

The remaining exceptions are supply of a building or parts thereof, and of the land on which it stands, other than the supply before first occupation and the supply of land which has not been built on other than the supply of building land as referred under „Taxable Persons“ of VAT Directive. These exceptions are due to the fact that the Croatian VAT Act taxes only newly built buildings (built after 1998 and sold by the entrepreneur – building enterprise or generally entrepreneur who is taxable person for the VAT). But even here land is not taxed by VAT then by the „real estate sales tax“ (rate of 5%). The same tax applies for the sale of „old buildings“ (buildings other than „newly build buildings“. These departures from the aquis need further correction, which will be connected with the “real estate sales tax” corrections.

To be completely precise, some elements of institutional principle are still present for medical services, education and social care, since they can be provided only by bodies by bodies governed by public law or by other similar bodies, but not corporations (Fabjančić and Kalčić, 2010, p. 34). Similar is true for educational services.
The new VAT changes include also introduction of the “margin scheme”, which is applied for second hand goods works of art, collectors' items and antiques, in accordance with the VAT Directive. However, for the time being the “sales tax”, which existence was criticized by the EU (Commission of the European Communities, 2004, p. 78), for used cars (5% rate) still remains in force, although it is planned to completely bring car taxation in line with the acquis (Hrvatski sabor, Nacionalni odbor, 2010, p. 6).

Among the special schemes, the exemption for the small taxpayers exists from the very beginning of the VAT in Croatia. The threshold was raised already one year later (in 1999) and now amounts 85,000 Croatian kunas (around 11.700 EUR). This is above the EU limit of 5,000 EUR. However, almost all EU Member States have the threshold above that level and that is accepted for the old EU Member States as well as for the new ones. Even more, due to the fact that maximum allowed threshold for the new members amounts 35,000 EUR (Council Directive 2006/112/EC, Article 287), Croatia plans to rise its threshold up to that amount.

Croatia still does not possess special schemes for agriculture, travel agencies as well as investment gold. It is planned to introduce such schemes for travel agencies and investment gold (Hrvatski sabor, Nacionalni odbor, 2010, p.6).

Free zones are still not included in the Croatian territory concerning VAT, so transaction connected with them are still regarded as “export.” To be more precise, the Free Zones Act has already made the relevant correction stating that the exemption will cease with the day of the Croatian accession to the EU, but the VAT Act still has not. It is expected that the necessary changes of VAT Act concerning all the necessary corrections will be done soon.

One of the most criticised departure from the aquis by the European Commission (http://europa.eu/legislation_summaries/enlargement/ongoing_enlargement/community_acquis_croatia/e10114_en.htm; Commission of the European Communities, 2004, p. 79; Komisija Europskih Zajednica, 2006, p. 46; Komisija Europskih Zajednica, 2007, p. 37; Komisija Europskih Zajednica, 2008, p. 46) was the lack of legislation for VAT refunds to non-established traders, which is finally corrected by the last VAT Act (from 2010).

Further smaller incompatibilities are also expected to be corrected soon.

2.2.5. Changes in excise duties: towards the EU

The development of excise duties (officially called “special taxes”) started even before the development of (corporate and personal) income taxes and, of course, VAT. The first excise tax, on coffee, was introduced in July 1993. A year after that came excise duties on petroleum products, tobacco products, alcohol, beer, non-alcoholic beverages, imported cars, other motor vehicles, vessels and airplanes. The excise duty on luxury goods was introduced in October 1999 and on premiums on motor vehicles insurance in 2002. Comprehensive energy taxation is introduced with the new Excise Duties Act (2009), which encompasses only EU harmonized classical excise taxes, leaving other “special taxes” aside. The new Excise Duties Act came into force on January 1 2010, but the taxation of gas, coal, coke and

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24 In is not surprising bearing in mind primary fiscal effects of such a taxes and a huge consumption of coffee in Croatia.

25 At that time its introduction was motivated by relatively „low“ top marginal tax rate of personal income tax (35%).
electricity will start with the Croatian accession to the EU (for the time being zero rates are stated for gas and electricity).

In its 1994 Opinion on Croatia's Application for Membership of the European Union, EC gave the main objections for excise duties (EC, 2004, p. 79-80). It also called for the planned adoption of uniform act for all products that are part of the EU harmonised excise system (i.e. alcohol and alcoholic beverages, tobacco products and mineral oils (at that time)\(^{26}\)) that should bring the legislation closer to the *acquis*, also by introducing a duty-suspension system for domestic movements based on the EU *acquis* and allowing more efficient control procedures. The EC pointed out that extensive adjustments would need to be made to the tax base, structures and definitions of most EU harmonised excisable goods. In general, the scope of the exemptions in these categories was not in line with the *acquis*, and some of the rates applied were well below the EU minimum levels.\(^{27}\)

Some important steps forward are done in 2009. In June 2009, Croatia has finally introduced the one single rate for cigarettes. Furthermore, new Excise Duty Act, as already mentioned, was introduced in July 2009. For the most part, the Act is harmonized with the EU Excise Directives, that is, particularly with general provisions covering the excise payment suspension system; excise warehouses; authorized excise storage providers; released user; and the provisions for excise taxes on energy, alcohol and tobacco products. Although that Act significantly improved the compatibility of Croatian excise duty system with the EU harmonization rules, some further adjustment is still necessary. This is especially true for coal, gas, electricity, minimum rates as well as small producers. Also the rules concerning car taxation should be brought in line with the *acquis*.

Some specific organizational problems as well tax evasion problems which refer especially to excise duties are discussed in the following chapter.

### 2.2.6. Organization and administrative cooperation

The tax collection and control is in Croatia divided between two bodies, both operating inside the Ministry of Finance. The bulk of taxes is covered by Tax Administration (IOTA full membership since 2001), which consists of central, regional and local offices. Division of its functions and tasks is presented in the following organizational scheme:

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\(^{26}\) Although beer was not mentioned here, it also belongs to the group of alcoholic beverages in Croatia and is encompassed by the new Excise Duties Act.

\(^{27}\) Concerning alcohol and alcoholic beverages, it was stated that Croatia appeared to allow an exemption for home-made production for own consumption of all categories of alcoholic beverages except beer. The EU *acquis* does not provide for such an exemption in the case of intermediate products and spirits. Croatia was also criticised to exempt from duty small breweries producing less than 1500 litres per year. For tobacco products, it was suggested that exemptions from duty would need to include denatured manufactured tobacco. Concerning mineral oils, the exemption of all kinds of heating oils were criticized. The scope of the exemptions was not in line with the *acquis*. As regards the level of excise duties, the rates applied to the above mentioned categories were in some instances below the EU minimum levels. This concerned in particular cigarettes and hand rolling tobacco, whilst a comparison with the EU minimum rates for alcoholic products, particularly beer, was not possible at that time because of the different structure of the duties. Concerning mineral oils, the rates of excise duties did not differentiate with regard to the use of the mineral oil. Liquid petroleum gas intended for any purpose – as well as other mineral oils – was taxed at a significantly lower level than the minimum rates provided for by the *acquis*. The level of rates applied to domestic and imported similar products was the same. Also the duty-suspension arrangement was not available to imported excisable products.
The operations of the customs service are carried out by the Customs Administration. It has a central office and several customs houses, which in turn have their branches or offices. Excise duties (and VAT on imports) by contrast to other taxes, are the responsibility of the customs administration.

In the Opinion on Croatia's Application for Membership of the European Union (Commission of the European Communities, 2004, p. 81) it was stated that Croatia’s experience was very limited for both VAT and excise duties. Necessary actions included in particular the development of IT systems for the exchange of information, the VAT Information Exchange System (VIES), the application for VAT on e-services, the System for Exchange of Excise Data (SEED) and the computerised system for the intra-Community movement and monitoring of excisable goods (EMCS). It was also underlined that the control strategy for VAT and direct taxes needs to be strengthened. The independent Department for Tax Crimes Investigation was criticized not to be well organised at that time. Serious delays have resulted from the lack of cooperation between the tax administration, the police and the judiciary. The VAT and excise duty evasion (especially smuggling of tobacco products – and to a lesser extent, of alcohol – through the Croatian border) were seen as the biggest problem. The main organizational problem was the excise duty service, which was criticized not to exist as a real functioning body within the administration. Hiring of new staff and systematic training of employees for both collection and control of excise duties was underlined as necessary, but also already planned.

Croatia started to work on the adjustment immediately. Limited strengthening of the excise duty service took place, a Financial Police department was set up in December 2004 and became operational in January 2006. Already in 2005 a team responsible for the VAT Information Exchange System (VIES) project was set up. In 2006 Croatia started to
participate in FISCALIS, participating in the Fiscalis 2007 programme. The tax administration adopted an IT strategy and work was done to increase operational capacity.

In 2008 the excise department in the customs administration has been reorganised into four units, to mirror the structure of the EU legislation. Work on IT interconnectivity has progressed and projects to develop the VAT information exchange system and the excise movement control system have started. During 2008 control and identification stamps were issued to taxpayers (for tobacco products, alcohol and alcoholic drinks and coffee. There was obvious improvement in the development of electronic services of Tax Administration especially concerning communication with taxpayers.

As already mentioned, exchange of information between member states of the EU concerning interest payments on savings income based on Savings Directive was included in General Tax Act in 2008 as well as administrative cooperation rules based on Directive 77/799 EEC and Directive 2008/55 EC (entering both into force on the day that the Republic of Croatia joins the EU.

At the 1st January 2009 the Personal Identification Number (PIN) – a unique mark of personal identification in all official registries was introduced (Ministry of Finance of the Republic of Croatia, 2008, p. 201). Until then there were no unique personal identifiers in the official registries, which resulted in the unequal recording and difficulties in connectivity and exchange of data about individuals among the bodies that keep data necessary for the implementation of administrative, tax and criminal proceedings in the official registries. Also, it was important to harmonize Croatian tax legislation with the acquis in regards to the determination of an identifier for international data exchange, which, according to the provisions of the acquis can have a maximum of 12 digits. With the introduction of the PIN, preconditions have been created for a networked administration, which will enable interconnectivity of all the official registries held on individuals and property in Croatia. By linking the data entered into the official records, timely and accurate monitoring of changes in the financial situation of citizens and legal persons will be enabled, for the purposes of the tax policy, and to increase the effectiveness of all governmental and other institutions. PIN is expected to help to fight corruption, increase the efficiency of the tax system, equitable distribution and equal treatment of all taxpayers

By the Regulation on the Amendments and Supplements to the VAT Regulation, tax exemption procedures have been prescribed pursuant to the Framework Agreement between the EC and the Croatian Government, and in regards to: Croatian participation in the European Community assistance programmes for projects financed by the European Community; and the Framework Agreement between the Croatian Government and the Commission of European Communities regarding the rules of cooperation in relation to financial assistance by the European Union to the Republic of Croatia within the framework of the Instrument for Pre-Accession Assistance (IPA).

II.3. Implementation of the PIFCS

Public Internal Financial Control encompasses a part of the principles acquis communautaire set up by the European Union as the overall internal financial controls system established for
the purpose of controlling, auditing and reporting on the use of national budget and European Union funds.

More precisely, since the year 2003 the Republic of Croatia undertakes intensive activities on the establishment and development of the internal financial control system according to the pre accession preparations for the membership in the European Union.

The European Commission published on 20 April 2004 a document titled “Opinion on the requirement of the Republic of Croatia for a membership in the European Union” where a concluding part emphasised that in the area of PIFC, the Republic of Croatia “has to develop general policies and harmonised legal framework. It has to establish or strengthen administrative capacities, functionally independent internal audit units in state institutions, and improve the required staff. The State Audit Office has the required legal and organisational background for further development into an adequate external audit body, but has to be strengthened. In the area of control over EU funds, the efficient mechanisms for monitoring, controlling and auditing EU funds will need to be developed. Besides, the Croatian administration will need to ensure the availability of the capacities for providing the effective and uniform protection of the EC’s financial interests. Under the condition that Croatia invests additional efforts in the reorganisation and strengthening of its capacities for Public Internal Financial Control, external audit and fight against fraud, it should be in the medium-term capable for meeting the EU requirements in this area.”

Regarding the PIFC acronym, it is very important to highlight that it represents both, the concept and the system. The PIFC was developed by the European Commission in order to support candidate countries in their internal control system reforms in the public sector. The concept has important role in representing and creating possibilities for establishment of higher standards of control over the public expenditures with the greatest emphasis on the “value for money” then it exists in the traditional models in the candidate countries.

Therefore, it is expected for the candidate countries to establish and develop the system of internal financial controls according to the concept which was in that field developed by the European Union based on international standards and the best practice of European countries, which is pretty demanding assignment for several reasons.

The best practice that was developed by some of the countries does not necessary mean the best practice for the rest of the countries, concerning the specifics of individual countries.

The process that would normally last 15 to 20 years of development is comprised in the period of 6 to 8 years, which demands extreme effort to establish and develop the system in such a short period.

To what extent will we improve the budget funds management by using the system of internal financial controls depends on how we perceive and develop the connection between these two systems.

During the last few years, the Republic of Croatia has been implementing extensive reforms aimed at developing public finance management.
Importantly, the aim of the reforms has been not only to meet the membership conditions but also to genuinely improve the public resources management and control systems, in order to prepare as a member-state for the challenges of membership and to make it possible to take advantage of the availability of EU funds.

With becoming a candidate country, the Republic of Croatia started in 2004 with the activities aimed at establishing and developing of this system, in line with the internal financial control concept as developed by the European Commission for this area.

In keeping with the set concept, the Republic of Croatia undertook numerous activities during the past five years to create all the necessary assumptions for the establishment and development of the system, including:

- the adoption of the initial strategic documents;
- drafting of laws and bylaws;
- the creation of organisational capacities and human resources; and
- the implementation of the system with budget users at central government and local levels.

The activities carried out to date have resulted in a significant progress, a fact also confirmed by the 2008 EC Progress Report for Croatia in its section on Chapter 32 – Financial Control. The alignment in respect of internal financial control system is being conducted under this Chapter.

2.3.1. Legal background for the PIFC establishment in the Republic of Croatia

The Internal Financial Controls system contains the following main components:

- Financial Management and Internal Control (hereinafter: FMC)
- Internal Audit (hereinafter: IA)
- Central Harmonisation Unit (CHU)

Negotiations on Chapter 32 – Financial Control were formally opened at the Accession Conference meeting at Ministerial level on 26 June 2007. In the EU Common Position on Chapter 32 it is stated that this Chapter may only be provisionally closed once it is agreed by the EU that the following benchmarks are met:

- Adoption and implementation of PIFC legislation and inherent policies supported by adequate implementation capacity;
- Safeguarding the State Audit Institution's functional and financial independence through amended constitutional provisions or national legislation having equivalent effect, adoption and implementation of necessary accompanying legislation;
- Alignment of the Croatian Criminal Code with the protection of the EU's financial interests (PIF) Convention and its protocols;
- Setting up an effective and efficient coordination service to guarantee the fulfilment of obligations arising from article 280 (3) of the Treaty establishing the European
Community and application of the provisions of Regulation (EC) No 2185/96 concerning the on-the-spot checks and inspections carried out by the Commission, in particular the obligation of assistance to Commission inspectors from the day of accession at the latest;

- Legislative and administrative alignment with Council Regulation (EC) No 1338/2001 lying down measures necessary for the protection of the Euro against counterfeiting, applicable from the day of accession at the latest.

Since the opening of accession negotiations on Chapter 32, Croatia has undertaken a number of actions and measures in order to meet the benchmarks set for the provisional closure of this Chapter, on which the Commission services have been regularly informed. This represents a final, comprehensive Report which addresses all the actions and measures taken by Croatia with respect to the fulfilment of obligations arising from the Negotiating Position of the Republic of Croatia and the EU Common Position on Chapter 32, including the set closing benchmarks.

The missions of representative of European Commission with the aim of assessment of conducted activities related to the Chapter 32 – Financial Control have been timely organized. The last one was in November 2009 where it was emphasized the role and responsibilities of the Audit Authority, allocation of the responsibilities and organization of the audit work, and possibilities of reliance on the work of other auditors.

2.3.2. Legislative framework

The beginning and development of internal financial control system in Croatia has occurred in 2003, when the first time in the regulation of the budget system was embedded the notion of internal audit. By the Budget Law of that period (OG 96/03) the internal audit was defined and the obligation of internal audit establishment at the budget users of state, local and regional level was prescribed.

Related to that Budget Law, in August 2004, the minister of finance has adopted the first Rulebook on internal audit by which the criteria for internal audit establishment, the internal audit work methodology, have been elaborated in more details.

The area of public internal financial control is regulated by the Public Internal Financial Control Act (OG 141/06) adopted in December 2006. The said Act defines in detail the framework for the establishment and development of internal audit and the system of financial management and control, as well as the methodology, standards, relationships and responsibilities within the internal financial control system.

Based on the provisions of the Public Internal Financial Control System Act, Croatia drafted and adopted all the relevant implementing legislation.

The Ordinance on internal audit of budget users (OG 35/08) and the Ordinance on public financial management and control implementation (OG 35/08) were adopted in March 2008. The Ordinance on internal audit of budget users stipulates the criteria for the establishment of internal audit units of budget users. The Ordinance on public financial management and
control implementation lays down a more detailed method of establishment and implementation of financial management and control.


In October 2009, the Risk management guidelines were drafted. The Guidelines are aimed to the highest managers in the budget users and to other employees involved in the risk management process. The purpose of the Guidelines is to unify the practice of the risk management at the budget users, and to set the limits to which will every budget user implement and develop the risk management.

A template of the Internal Auditors’ Charter was drafted in January 2008, laying down the rights and obligations of internal auditors as well as officials and heads of the budget users, to be used by internal audit units in preparing their copies.

In January 2008, the Minister of Finance, with the prior approval of the Croatian Government, issued a Professional Code of Ethics for Internal Auditors (OG 18/08), laying down the principles and rules to be adhered to by internal auditors in the performance of their duties.

Furthermore, the new Ordinance on budgetary control (OG 20/09) stipulates that control shall be carried out only pursuant to petitions of citizens, requests submitted by central bodies of public administration, local and regional self-government units and other legal entities, and not, as it has been the practice until now, pursuant to the adopted control plans.

All activities envisaged in the 2004 Development Strategy of the Public Internal Financial Control in the Republic of Croatia, and in the improved version of the 2005 Development Strategy of the Public Internal Financial Control have been completed. The 2004 and 2005 strategic development documents referred to the central state level, while the Independent Development Strategy of Public Internal Financial Control in the Republic of Croatia for local and regional self-government units was adopted in November 2007.

Moreover, the activities referred to in the Action Plan for the establishment and development of the Public Internal Financial Control in the Republic of Croatia by the end of 2008, which was adopted on 5 April 2007, were carried out according to plan. The new Plan for further development of Public Internal Financial Control in 2009 was adopted in January 2009, with the aim of further development of the public internal financial control system. The most important activity envisaged by the new Plan is the drafting of the Development Strategy of Internal Financial Control for the period 2009-2011. The Strategy was adopted by the Government of Republic of Croatia in September 2009 and presented to the highest level of state and local officials and internal auditors. The new Strategy puts more emphasis on stronger connectivity of the internal financial control system with the budget system with the aim that further development of this system is in function of support to the budget reforms.

The new Budget Act (OG 87/08) was adopted in July 2008 which excluded the provisions on internal audit. By adoption of the aforementioned Budget Law, there have been firm legal grounds for the realization of the measures created.

With respect to the relation of the objectives and the budget funds, it is important to emphasise that the new Budget Law obliged the budget users to establish strategic plans.
The strategic plans for three-year period contain: vision, strategic objectives, the models of objectives implementation, measures for result estimation and the monitoring system.

The Strategic plans do not represent the supplement for the existing strategic documents and the planning acts, since they create the relation between the existing strategic documents and the budget, and therefore connect the objectives and the budget funds.

The new Budget Law creates better conditions in the control environment of the budgets users.

In line with the Administrative Co-operation Agreement between the Ministry of Finance of the Republic of Croatia and the Directorate General for Budget of the European Commission, regular communication and exchange of opinions regarding the proposals of legal acts and subordinate legislation defining the establishment and development of the Public Internal Financial Control System in Croatia has been taking place.

2.3.3. Administrative framework

The Professional training programme for acquiring the qualification of a Certified Public Internal Auditor and Instructions on skills assessment, and passing of the exam for acquiring the qualification of a Certified Public Internal Auditor, were issued by the Minister of Finance in March 2007. The Internal Auditors’ Training Plan for the period 2008-2010 was adopted in January 2008 and is currently being implemented.

The Training Strategy for Persons in charge of the Establishment and Development of Financial Management and Control was adopted in February 2007. The Strategy envisages two types of seminars: awareness-raising seminars on financial management and control, and professional training in financial management and control. Consequently, budget users on the state level have appointed persons in charge of financial management and control.

The Professional training programme for financial management and control was issued by the Minister of Finance in March 2007, and according to this programme, persons in charge of establishing, developing and implementing financial management and control have been professionally trained. The training programme consists of four basic modules, and its purpose is to get the attendees acquainted with the system of financial management and control, and the activities that have to be implemented in order to establish and develop this system, all with the aim of improving financial management and decision-making so that the users’ objectives can be realised.

Internal audit units have been established at all ministries and other state bodies, the City of Zagreb and in individual counties, county centres and large cities.

Professional training programmes for persons in charge of financial management and control have continuously been performed since November 2006, and number of seminars that include basic and additional modules for financial management and control have been organised to date.
In the period June – December 2008, the Central Harmonisation Unit established active cooperation with the institutions responsible for implementing activities under the EU pre-accession funds (the National Fund, Central Finance and Contracting Agency, the Central State Office for Development Strategy and Coordination of EU Funds, and the Agency for the Audit of Implementation of EU Programmes). In cooperation with the aforementioned institutions, the Guidelines for implementing audit of the operation of Project Implementation Units (PIUs) for CARDS, PHARE and IPA I Programmes were drafted in July 2008. In addition, in January 2009 the Guidelines for the development of cooperation between the Agency for the Audit of Implementation of EU Programmes and Internal Audit (within the IPA and SAPARD systems) were drafted. Furthermore, the cooperation between the Central Harmonisation unit and the State treasury has been stepped up. Furthermore, the Guidelines for implementing audit of project contract implementation under CARDS and PHARE programmes were issued in July 2009.

With the objective of greater operative involvement of the Public Internal Financial Control Council in future development of the internal financial control system, in November 2008 the Croatian Government adopted the Decision on appointment of new members of the Public Internal Financial Control Council, which, among others, consists of the Chief State Treasurer, the National Authorising Officer, and the Director of the Agency for the Audit of Implementation of EU Programmes.

The newly assembled Public Internal Financial Control Council met in February 2009 and discussed the detected weaknesses of the internal financial control system. Following the proposal of the Public Internal Financial Control Council, in March 2009 the Croatian Government adopted a Conclusion obliging the heads of the state budget users to fill the vacant posts in internal audit units (particularly the heads of the state budget users which are beneficiaries of EU pre-accession funds). Furthermore, this Conclusion obliges the heads of the state budget users to place the coordination of creation and development of financial management and control under the authority of the existing finance and budget units.

Besides the financial management and control and internal audit, the third element of the PIFC concept is Central Harmonization Unit which is the organizational unit in the Ministry of Finance responsible for coordination of the activities of establishment and development of internal financial control system in the public sector.

Central Harmonization Unit was established in April 2005, as the Directorate for harmonization of internal audit and financial control in the Ministry of Finance. At the beginning it was important to embed significant engagement on drafting the regulatory framework, and also on staff capacities, especially in the field of internal audit, since the establishment and development of internal audit has actually meant the creation of the new profession for the budget users in the public sector of Republic of Croatia.

Commencing activities under the competence of the Central Harmonisation Unit, and taking into consideration the functional divergence of financial management and control and internal audit, a new organisation of the Central Harmonisation Unit has been proposed. Therefore, on 26 February 2009 the Croatian Government adopted the amendments to the Regulation on internal organisation of the Ministry of Finance (OG 29/09), amending the structure of the Central Harmonisation Unit in accordance with the tasks within its competence. Three services have been established, namely: the Service for Methodology and Standards, the Service for Training Coordination and Quality Control and the Service for International Activities.
2.3.4. Objectives and measures of further internal financial control development

Starting from the current basis in the development of this system and taking into account of budget system developments initiated by the budget reform, as well as the experiences gained from the development of internal financial control system in the pre-accession funds, the Public Internal Financial Control System Development Strategy for the period 2009-2011 has three core objectives:

- to determine further developmental directions for the public internal financial control system in order to achieve its contribution towards more accountable, transparent and successful management of public resources, regardless of their sources;
- to support the implementation of budget reforms through the development of internal financial control systems;
- to ensure general consistency of the internal financial control system development for both national and EU resources used through the EU pre-accession funds, while taking into account certain specific requirements.

The most important activities envisaged in this Strategy aimed at further developing the internal financial control system follow the path below:

- raising awareness of financial management as an integral part of management process in general;
- strengthening the roles of the existing finance directorates/sectors for the need of coordinating the financial management and control establishment and development activities and providing support to other sections of managerial structures taking part in financial management;
- development of financial management and control in the budget cycle processes;
- development of cost and management accounting as the foundation for good quality financial information systems needed for financial management purposes;
- development of risk management process;
- strengthening internal audit in terms of its competence and scope of work;
- more efficient use of the existing auditing resources by carrying out horizontal and vertical audits and the creation of specialised auditing teams;
- development of a quality assurance model to be applied for the evaluation of the established internal financial control systems.

Experiences gained in the development of the internal financial control system for managing the EU pre-accession funds can be used of great value for the development of this system for the national needs.

During previous periods, the Central Harmonisation Unit was intensively involved in the creation of the regulatory framework and the prescription of work methodology. In the period to come, CHU will focus more on strengthening its coordinating role, linking the participants in the development of this system, and the development of quality assurance model for the system established.

III. The setting of governmental accounting in Croatia - development, general features and international perspective
3.1. Governmental accounting trends

Fundamental features of accounting information system are determined by the chosen accounting basis that determines whether certain economic event would be recognized in the accounting system or not. Precisely, chosen accounting basis defines when an item is measured in the accounting system and more importantly what is measured within the accounting system (cash balances and changes there in or/and economic resources and changes therein), and in that way it determines the quality of accounting information. The status and development of governmental accounting at the international level encourages strongly the accruals implementation. A substantial literature has shown that the governmental accounting reform, among other things, consists of introducing accrual accounting in governmental organizations (Lüder & Jones 2003; Brusca & Candor 2000). According to Christensen (2002), accrual based financial reporting has been significant amongst the accounting technologies that have dominated the overall public sector management reform, internationally known as the New public management (NPM) concept. To date International Public Sector Accounting Standards Board (IPSASB) has issued 26 accrual-basis International Public Sector Accounting Standards (IPSAS) reflecting an array of international trends and views concerning governmental accounting development (IFAC 2003). As previously demonstrated (Luder & Jones 2003; Roje, Vašiček & Vašiček 2008; Vašiček & Roje 2008) these trends refer to harmonisation process that evolves in several directions:

- the convergence of IPSASs towards IASs and IFRSs (induced by accruals implementation in general government sector),
- the harmonization of national and international accounting standards for public sector,
- the harmonization of information systems (accounting systems’ and statistics systems’ harmonization, fostered by accrual based Government Finance Statistics that are considered as a path towards establishing contextual and functional linkage concerning financial and statistics reporting on public spending),
- the development of cost and managerial accounting instruments within the public sector in the course of enhancing harmonization of internal and external reporting.

These directions refer to a convergence of public and private accounting systems that would result in transparent, standardized and internationally comparable accounting basis, which would consequently decrease diversifications of accounting systems and improve the quality of government reports, most importantly regarding public expenditures. According to Grossi (2006), besides the countries that have been currently adopting the accruals and complying with almost all of the IPSAS requirements (e.g. Australia, Finland, Iceland, Canada, Sweden, New Zealand), a wide range of national governments with the intention to change to the accrual basis have expressed the will to consult IPSAS (e.g. France, South Africa, United Arab Emirates, Netherlands, Malta, Hong Kong, Thailand, Cayman Islands, Mongolia, Israel).

IPSASs have also been adopted by some international bodies (e.g. Organisation for Economic Co-operation and Development – OECD) while some countries and supranational organisations (e.g. European Commission) have used them to inform their own standard-setting processes as they move to the full accruals basis of reporting.
In certain countries where neither national public sector accounting standards have been developed, nor IPSASs appliance required by law (e.g. Croatia), the implementation of certain accounting solutions defined by IPSASs has been recommended in legislation applicable to the governmental accounting and financial reporting (Vašiček 2004; Vašiček 2007; Roje, Vašiček & Hladika 2009).

3.2. Governmental accounting in Croatia

3.2.1. Development and general qualitative features

Historically, Croatian national governmental accounting system had been influenced by the cameral accounting theory. Since it had been developed to monitor and control the balance between planned and actual amounts of all state revenues (cash inflows) and expenditures (cash outflows) for a certain period, single entry cash transactions had been a sufficient solution. Additionally, its budgetary system has in fact influenced the accounting system as it has been a common feature of Continental European countries (Monsen & Oulasvirta 2007). Consequently, the governmental accounting information system’s structure and contents has been viewed primarily in function of State’s budget goal achievements and less in function of achieving greater management efficiencies and hence better outcomes (Vašiček 1998).

Broadly speaking, it can be pointed out that in the period before 1990 governmental accounting was weakly present and subordinately elaborated (if compared to commercial accounting) within Croatian literature. There was not enough research done nor much discussion held, both in theory and practice, regarding the development of governmental accounting and primarily the role of its accordingly adjusted accounting information system as a precondition for efficient public sector management. Governmental accounting information system was at that time regarded as a purely administrative – oriented and its managerial impact was disregarded. This was mainly caused by the long period of a planned economy. Consequently, in an economic system in which the government controlled all major sectors of the economy governmental accounting happened to serve the prior purpose of monitoring and controlling the budgeting processes. Therefore, governmental accounting happened to be more in function of national accounts. Thus statistics information systems were given priority with respect to accounting information systems and financial reporting.

Ever since 1991, when Croatia gained independence, much effort has been placed towards establishing a public expenditures´ financing model and towards changing the accounting and financial reporting systems. Since the year of 1993, when the Budget (Finance) Act was passed28, the Croatian governmental accounting system has progressed, from pure cash accounting practice period, that was soon after replaced with modified cash basis (that manifested in longer fiscal year period), towards the implementation of modified accrual basis in financial reporting that started in the year of 2002 (that manifested in accounting for bigger array of transactions on accrual basis), as a part of the accounting system reform that commenced in 2001.

The choice and obligatory aspects of cash basis appliance was based upon the fact that all information contained in the financial statements should serve primarily as a qualitative basis for the budget execution and liquidity control. Such a system was perceived as an integral system of the State Treasury, as an administrative organisation in the Ministry of Finance, for the purpose of managing public expenses. However the need for considering such a system as a part of an integral modern governmental accounting information system emerged. Consequently, on the path of acknowledging the modern international trends of public expenditures’ comparability and transparency that started worldwide in recent decades, in the year of 2002 new governmental accounting system was established in Croatia. As already mentioned, the accounting system reform started in 2001, and ever since Croatia has been trying to follow the international developments towards the introduction of accrual accounting within the national general government sector. The later regards the implementation of modified accrual accounting as a gradual transition from cash basis to accruals (Vašiček 2004; Vašiček 2006). More importantly, as a part of the new governmental accounting system several rather unique and theoretically and scientifically interesting practical solutions were implemented to assure pursuing public expenditures using cash and accrual basis simultaneously. These are as follows:

- its’ existing government accounting/financial reporting system has been based on modified accruals as a gradual transition from cash basis to accruals,
- approved budget(s) are made publicly available,
- budget amounts are cash based,
- national public sector accounting standards have not been developed,
- IPSASs appliance has not been mandatory required, but the implementation of certain accounting solutions defined by IPSASs has been recommended in Croatian legislation.

The fact that certain existing procedures/solutions applied in Croatian public sector accounting practise comply with those recommended in IPSASs, even though IPSASs have not been enacted on a mandatory basis, provokes the need to examine areas where IPSASs have been influential in Croatian public sector accounting practise, and to specify certain eligible tendencies and possible courses towards more comprehensive compliance with IPSASs (Roje, Vašiček & Hladika 2008; Roje, Vašiček & Vašiček 2008; Roje, Vašiček & Vašiček 2009).

A high degree of normativism is deemed as one of the important features of Croatian government accounting system. Since governmental activities have been financed through the Budget, the legislative framework regarding governmental accounting development was determined by the Budget (Finance) act (The Act) and other additional set of regulations. Those additional regulations, decrees, instructions, policies, define and analyze certain parts of the main Act more precisely and thus enable faster and easier qualitative adoption of regulated solutions. In addition, since accounting framework in Croatia has been set up as a

29 Uredba o računovodstvu proračuna, Narodne novine br. 94/04, 108/96 (engl. Decree on government accounting, Croatian national gazette, No. 94/04, 108/96)
30 According to Government Finance Statistics (GFS) 2001, public sector refers to general government (i.e. central and local government) and their governmental entities, and state owned enterprises.
32 Set of regulations include the following: Zakon o proračunu (Nar. nov. 96/2003) / in English: The Budget Act, Pravilnik o proračunskom računovodstvu i računskom planu (Nar nov. br. 27/2005)/ in English The Policy for budgetary accounting and Chart of Accounts, Pravilnik o finansijskom izvještavanju u proračunskom
law-based system, national public sector accounting standards have not been developed.\textsuperscript{33} Despite the non-existence of national public sector accounting standards, the appliance of IPSASs has not been enacted as obligatory, though the implementation of certain accounting solutions defined by IPSASs has been recommended by aforementioned set of Croatian regulations.

There may be various reasons for such a high degree of governmental accounting normativism. Firstly, Croatian independence was declared in 1991 and the planned economy was changed to the market-driven one. Secondly, there has been high degree of public finances’ centralization, public expenditures’ have been financed through central Budget, and there has been an obligation to consolidate reporting on public expenditures. In addition, as a part of the inevitable process of adjusting its system towards the one of the EU, Croatia has had to take into account different international institutions’ requirements, etc.

The distinguished qualitative features of the existing Croatian governmental accounting system are as following (Vašiček 2004)\textsuperscript{34}:

- All general government entities (central and local government and their component entities) are obligated by the law to apply governmental accounting and financial reporting model.\textsuperscript{35} The fact that all entities within general government are obligated to do so, assures complete accounting and reporting on general government activities.

- Unified chart of accounts and consistent appliance of rules for recording cash transactions and economic events are regulated by the law as well. This assures standardized information base for conducting additional data analysis when needed.

- As regards information on budget (budget planning and budget execution), accounting and financial reporting, the appliance of organizational, economic, functional, location and program classifications of the budget is obligatory.

- Existing accounting information system of a general government has been regulated to be based on modified accrual accounting basis and the historic cost principles regarding balance sheet items, as a gradual transition towards accruals implementation and compliance towards the IPSASs. Generally, modifications of accrual accounting basis vary. This allows governments that have not yet applied full accrual basis to model their own accounting system by adjusting it according to their particularities (e.g. with respect to quality of an existing accounting system, the willingness and qualifications of the public sector accounting staff, taking into account the priorities in conducting reforms, the level of political will to introduce changes, international requirements and level of necessity to complete the reform etc.). Even though actual amounts and financial statements are prepared on modified accrual accounting basis, budget amounts are still

\textsuperscript{33} As for the financial reporting standards for private sector are concerned, a final draft of National financial reporting accounting standards for private sector/ HSFI – Hrvatski standardi financijskog izvještavanja, has been developed in the beginning of 2008, primarily as a support for small and medium entrepreneurs that find it hard to follow the IFRS – International Financial Reporting Standards. Prior to 2008, the appliance of IFRSs had been enacted as obligatory for big companies listed on the Stock Exchange, and just optionally for all the others.

\textsuperscript{34} Adopted and adapted from Vašiček, V 2004, ‘Stanje i pravci razvoja računovodstva proračuna’, Zbornik XXXIX. simpozija HZRFD, Financijski i računovodstveni aspekti korporativnog upravljanja u profitnim i neprofitnim subjektima, Pula, Croatia, May.

\textsuperscript{35} The term „component entities“ refers to departments, boards, agencies, commissions etc.
prepared on cash basis. However, this is consistent with the international trend that within
the set of accounting system reform implementing accruals in financial reporting comes
first and accrual based budgeting follows.

- The most important features of Croatian governmental financial reporting model based on
modified accrual accounting basis are as follows:  
  - revenues are generally recognized on cash basis with only certain revenues recorded
    on accrual basis,
  - regular expenditures and liabilities are recognized on accrual basis,
  - expenditures regarding the fixed assets supply are not capitalized but rather treated as
    an expense in full when obtained. This further implies that assets are not being
    depreciated yearly based on the estimated assets usage period.

- Consistent appliance of internationally recognized and comparable analytical framework
  of financial and statistics reporting has resulted in establishing contextual and functional
  linkage concerning financial and statistics reporting. Precisely, one of the reasons for
directing accounting information system reform towards accruals implementation is the
fact that Government Finance Statistics (GFS 2001) are accrual based.

- Obligation to make periodical and annual financial reports; obligation for consolidated
  semi annual and annual settlement of budget accounts of the Republic of Croatia.

Taking into account all abovementioned features, it is inevitable to articulate that the
transformation from cash accounting basis to modified accrual accounting in 2002., enabled
Croatian governmental accounting system to make a valuable step further towards
international public sector accounting reform trends. The reform has so far resulted in
implementing quality solutions that represent a good basis for further adjustment and
development of Croatian governmental accounting information system towards more
comprehensive appliance of IPSASs.

3.2.2. Accounting for Non-profit organizations

As previously emphasised according to Government Finance Statistics (GFS) 2001, public
sector refers to general government (i.e. central and local government) and their
governmental entities, and state owned enterprises. General government sector includes also
the so called non–profit organisations if they are mostly controlled by the State, founded and
owned by the State, and are mostly (more then 50%) financed through the Budget. The first
year after the Croatian accounting system for non-profit organizations (so called fund
accounting) was initially set up (1993), it encompassed all non- for profit organizations, no
matter whether they were financed privately of through the Budget. The prior purpose of fund
accounting system has been to show through the financial statements how the public money
had been spent. Soon after those organizations that were mostly financed by the State funds
started to be obligated to run the accounting practise as other general government sector
entities did, the accounting practise for the remaining non-profit organizations (that were
mostly financed and founded privately) did not change. Ever until 2008, those organizations
conducted fund accounting that was characterised with the modified accrual accounting basis
being implemented. The use of fund accounting has often been a topic of debate in the
accounting profession who has questioned its usefulness, particularly in the standard-setting

process, for it did not referred to modified accrual accounting basis, instead it de facto referred to the modified cash accounting basis implementation:

- Revenues were generally recognized when the criteria of revenues being realizable (availability criterion) and appreciable are satisfied. The availability criterion refers to revenues being recognized when it is likely that they will be collected (recovered) within 20 days after the reporting period.
- Regular expenditures were recognized in the period they were incurred, under the condition that they were settled within 20 days after the reporting period, the latest.

Such accounting practise has been abandoned in 2007. In the year of 2008, the accounting system for non-profit organisations in Croatia has been reformed greatly, in a way that it has converged to the business sector practise, and it is now full accruals based.

### 3.2.3. Financial reporting and financial statements in Croatian budgetary system

Since governmental activities are financed through budget execution, governmental accounting is sometimes in Croatian literature referred to as „budgetary accounting“. If so, the term budgetary accounting does not address accounting for the budget only but also it addresses the financial reporting for governmental entities that are also financed through the budget.\(^{37}\)

The purpose of the financial statements is to meet the common need of gathering the quality information that most users require when making various decisions. Pragmatic and comparable criteria in a form of accounting standards, applied when compiling and presenting the financial statements, contribute to the quality of accounting information presented in a standard form of the financial statements. Appropriate reporting system is defined in accordance with established accounting information system that is based on modified accrual basis of accounting. Analytical framework of financial reporting which has reached a high degree of reporting system universality and which serves as the basis for international reporting is defined in accordance to the current processes of harmonization of accounting and statistical standards. Certain discrepancies are still present precisely because the budgetary accounting in the Republic of Croatia is based on the application of modified accrual basis of accounting, as opposed to the GFS 2001 which is based on full accruals (Roje, Vašiček & Hladika 2009).

Entities obligated to prepare the basic financial statements are the state budget, the budget of local entities and extra-budgetary users. All budgetary users compose their financial statements on mandatory basis and they submit them to the hierarchically superior ministries in accordance to the deadlines prescribed by the Policy for financial reporting in budget accounting. Ministries coordinate and consolidate financial statements of their budget users with their financial statements. The primary purpose of financial statements is to provide the users with the information about the financial position, regarding their performance in fulfilling the goals, and the information about the budget and its’ users cash flows. Financial statements are compiled for monthly periods, for the period from 1st of January to the 31st of March, for the period from 1st of January to the 30th of June, for the period from 1st of

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\(^{37}\) The term budgetary accounting can also refer to accounting that serves the function of budgetary control in the sense of comparing spending against the budget.
January to the 30th of September, and for the whole budget year (12 months). Thereby, the financial statements for interim periods are stored until the day when annual financial statements are presented, while annual financial statements are stored permanently.

The financial statements comply with the IPSAS 1 requirements and the complete set of financial statements comprises the following statements: the balance sheet, the report on changes in assets’ and liabilities’ volume, the report on revenues, expenditures, cash receipts and expenses, the cash flow statement, and the notes (as the financial statements supplement). Together with preparing the aforementioned financial statements, budget users compose additional financial statements, and these are the following: the statement of expenditures according to functional classification, the statement of liabilities, and the statement of revenues and expenditures of budget users.

Along with the basic financial statements that budget users prepare, the Budget Act stipulates the obligation of drawing up the consolidated financial statements. The purpose of the consolidated financial statements is to show the true and reliable information of the fiscal position and operations of the general government. Therefore, it is necessary to clearly determine who the budget users are and on which level they are obliged to consolidate. The legal requirements for the consolidation that are to be met in order to gather the true and reliable consolidated financial statements, encompass the prescribed accounting methodology, the unique Chart of accounts that is obligatory and that cannot be changed independently, the unique accounting policies, and the ordered financial reporting system based on a prescribed deadlines and clearly defined coverage of the obliged entities.

Having in mind that the ultimate goal of consolidation in the budgetary system is to compose the consolidated financial statement of general government, this goal is achieved by the implementation of a three level consolidation. These levels are as follows (Roje, Vašiček & Hladika 2009):

- On the first level, ministries and local governments consolidate financial statements of their budgetary users. Each of the extra-budgetary funds composes unique financial statement for a group.
- On the second level, the first level consolidated financial statements of the group consolidate with the financial statements of the budget (state or local budget).
- On the third level, financial statements of the state budget, extra-budgetary funds and other central state entities (consolidated central state) are consolidated with the consolidated financial statement of the local budget. It is necessary to eliminate all transactions between the state budget, extra-budgetary funds and other entities in the central state and local budget, to create the consolidated statements of the general government.

At each level of consolidation, it is necessary to disclose the notes as the financial statements follow up to provide information about the conducted elimination. The Ministry of Finance consolidates the consolidated financial statements of the ministries and financial statements of the extra-budgetary users and composes the financial statement of the state budget. In addition, The Ministry of Finance consolidates the consolidated financial statements of local and regional governments and composes the general financial statement of local and regional

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38 Pravilnik o financijskom izvještavanju u proračunskom računovodstvu/ in English The Policy for financial reporting in budget accounting (Croatian Official Gazette, No. 27/2005, 2/2007., paragraph 3.)
governments, as well as it consolidates the financial statement of the state budget and financial statement of local government and comprises the consolidated financial statement of the Budget of the Republic of Croatia.

### 3.2.4. The adjustment process of the Croatian public sector accounting with the EU

During the current adjustment process of the Croatian legislation with the EU, it is necessary to construct a new system of financial monitoring and reporting on the activities of all segments of the public sector, particularly governmental institutions. The aim of the new reporting system should be financial monitoring and support of the new public management that would drive the public sector by economic principles of efficiency and effectiveness. During the oversight and control of its activities and of his work there are certain peculiarities in relation to the business sector. Its success is measured by a degree of satisfaction of public and common needs by measuring the volume and quality of services provided in relation to the available and consumed resources. Market valuations and market assessments of the effectiveness of public management are constricted by the role of the market in meeting public and common needs. There are no market prices or other market criteria for the assessment of the quality of the provided goods or services. Such non-market public or common goods or services need some other benchmarking criteria. For this system to work properly, a new system of accounting is needed. An accounting system that shall encompass all available inputs and outputs according to several criteria: organisational, economic, functional, locational, and sources of funding.

Successful governmental management implies fiscal transparency as a precondition for greater credibility of the government and provides support for macroeconomic stability. To monitor the public management, it is necessary to set up a comprehensive information system. Comprehensiveness ensures the application of accounting concepts and methods that do not constrict included information to the portion of available resources and debt, but a system that includes all the resources completely.

From the research, a hypothesis is drawn, that from the features of different accounting systems, with differently shaped and applied foundations, it is possible to draw a set of concepts and methods that will be effectively used to assess the effectiveness of the governmental reporting unit as an economic entity.

It is expected to set the system to be complementary to, on a global scale, a newly set-up financial reporting system that will not only be conformal to the profit-maximizing interests of the capital investors but which have to satisfy the interests of all concerned segments of the human community: investors, employees, the central government, the consolidated general government and the public sector in general as also the other identified economic groups.

Fully in line with these objectives, the system of financial reporting of the government and the general public sector as economic entities should attain a higher degree of universality, which will be determined by their compliance with the requirements of the International Public Sector Accounting Standards and the requirements of the international statistical reporting on how the governmental and public sector is run from an economic perspective.
3.2.5. Application of the Budgetary Classification Rules

Ministry of Finance has drafted new rules on budgetary classifications, which entered force after publication in the Official Gazette nr. 26/2010 (in March 2010) and will be applied for the first time during the planning process for the period between 2011 and 2013. The budgetary classification is a framework in which income, receipts, expenditures by holder, objective, purpose, type, location and source of funding are systematically presented, and monitored. Within the glossary of the Budget Law (Article 3), the budgetary classification is defined by each component of the classification:

- **The organizational classification** shows hierarchical relations between budget users with respect to their rights and responsibilities.

- **The economic classification** shows revenue and receipts according to their natural species, and expenditures by economic purpose they serve. They are divided into classes, groups, subgroups, sections and basic accounts,

- **The functional classification** shows budgetary expenditures, and budgetary and extrabudgetary users classified according to their purpose.

- **The locational classification** shows expenditures according to territorial units defined according to the structure of the Republic of Croatia, the European Union and other countries.

- **The classification according to sources of finance** and its components shows activities and projects, as defined in accordance with the planning legislation and objectives and tasks of the budget. Budgetary and extra budgetary users and sources of funding are groups of income and receipts from which the expenses and expenditures are paid, as also some other types of activities that serve as sources of income.

Former Law on Sources of Funding did not identify the classification. Their subsequent definition was a prerequisite for the functioning of the single treasury account. During the 2007 budgetary year, the funding sources have been introduced as a separate classification. The following table shows the current classification in a functional and economic classification matrix:

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<th>Functional</th>
<th>Economic</th>
<th>Payroll expenses</th>
<th>Material expenses</th>
<th>Financial expenses</th>
<th>Subventions</th>
<th>Grants</th>
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IV. Conclusion

The framework and objectives of the economic and fiscal policy of the Republic of Croatia are defined in a series of strategic documents of the Government of the Republic of Croatia, namely: the Strategic Development Framework for 2006-2013, the Government Programmes Strategy 2010-2012, the Economic and Fiscal Policy Guidelines and the Pre-accession Economic Programme (PEP). These documents determined the medium-term economic and fiscal policy goals such as to preserve macroeconomic stability; optimum environment for the development of competitive economy; strengthening the state of law and the rule of law: promoting knowledge, excellence and culture; uniform regional development; strengthening social equality; positioning Croatia as one of the leading European tourist destinations; more competitive sector of agriculture, food industry and fisheries; further strengthening of the international status; improving the police and armed forces; improving and maintaining health care system; environmental protection and spatial development.

There are numerous measures within the reform of the public sector necessary to achieve the stated goals. In this paper, only some of the most important are elaborated. It can be stated that one of the most important improvements was adoption of the new Budget Act that serves as a foundation for further reforms and rise of efficiency in the public sector. There are also numerous activities of the Government directly or indirectly related to the structural issues that trouble the economy such as the privatization process, labour market, and support to the small and medium size enterprises, social security system and other. Very dynamic process of tax harmonization lead to significant results regarding the convergence of the Croatian fiscal system. It has to be stated that negative impacts of the global financial crisis undermined the position of public finances, however, in certain way, this provided stimulus for even faster pace of reforms.

Reform process consists of implementing the new Public Internal Financial Control system which encompasses a part of the principles *acquis communautaire* set up by the European Union as the overall internal financial controls system established for the purpose of controlling, auditing and reporting on the use of national budget and European Union funds. This system also supports the implementation of budget reforms through the development of internal financial control systems and ensures general consistency of the internal financial control system development for both national and EU resources used through the EU pre-accession funds, while taking into account certain specific requirements. More precisely, since the year 2003 the Republic of Croatia undertakes intensive activities on the establishment and development of the internal financial control system according to the pre-accession preparations for the membership in the European Union.

Fundamental features of accounting information system are determined by the chosen accounting basis that determines whether certain economic event would be recognized in the accounting system or not. Chosen accounting basis defines when an item is measured in the accounting system and more importantly what is measured within the accounting system (cash balances and changes therein or economic resources and changes therein), and in that way it determines the quality of accounting information. The status and development of
governmental accounting at the international level encourages strongly the accruals implementation. Therefore, the convergence of public and private accounting systems should result in transparent, standardized and internationally comparable accounting basis, which would consequently decrease diversifications of accounting systems and improve the quality of government reports, most importantly regarding public expenditures.

During the current adjustment process of the Croatian legislation with the EU, it is necessary to construct a new system of financial monitoring and reporting on the activities of all segments of the public sector, particularly governmental institutions. The aim of the new reporting system should be financial monitoring and support of the new public management that would drive the public sector by economic principles of efficiency and effectiveness. For this system to work properly, a new system of accounting is needed. An accounting system that shall encompass all available inputs and outputs according to several criteria: organisational, economic, functional, locational, and sources of funding.

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