

# Public Sector Economics - Situation, problems, possible solutions and research

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**Ott, Katarina; Kesner-Škreb, Marina; Bajo, Anto; Bejaković, Predrag; Bubaš, Zoran**

*Source / Izvornik:* **Newsletter : an occasional publication of the Institute of Public Finance, 2000, 2, 1 - 32**

**Journal article, Published version**

**Rad u časopisu, Objavljena verzija rada (izdavačev PDF)**

*Permanent link / Trajna poveznica:* <https://urn.nsk.hr/urn:nbn:hr:242:856879>

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*Download date / Datum preuzimanja:* **2024-04-14**



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# NEWSLETTER

Institute of Public Finance, HR-10000 Zagreb, Katančićeva 5 Croatia  
 P.O.Box 320, Phone: (385 1) 4819 363; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

No. 4 – February 2000

Katarina Ott\*, Marina Kesner-Škreb, Anto Bajo, Predrag Bejaković i Zoran Bubaš

## Public Sector Economics

### The state of affairs, problems, and possible solutions

At almost the same time, Croatia got a new parliament, a new government and a new president. We would like to help them all to succeed in grasping the complex questions of public sector economics. It is for this reason that, on the foundation of our work and research to date, we have drawn up a text entitled: "Public Sector Economics - The state of affairs, problems, and possible solutions".

Although by very definition a newsletter should be short, this time, exceptionally, because of changes in society that are so important, we are publishing a longer, integral text. We hope that the views and possible solutions stated will make their way to the public and to representatives of the public who are charged with making the key decisions. We also hope that it will stimulate other experts to make their own views heard and contribute to a reasoned debate, to the launching of further research, and to better approaches to public sector economics.

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\* This work was supported by the Research Support Scheme of the Open Society Support Foundation, grant No.: 957/1999"

**The Institute for Public Finances deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute for Public Finances is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>**

## Summary

- The Croatian public sector needs to be different, smaller and more efficient than hitherto. For this it is essential to see the development of institutions appropriate to a market economy, to have help in the development of a new, competitive economic structure and the application of broad-based instead of selective measures of state intervention.
  - Better management of public expenditure requires reform of institutions, which means the consistent application of existing laws related to the budget, and the improvement of the work of the budgetary institutions.
  - It is essential to fix on the optimum degree of fiscal decentralisation in which, in addition to authority to finance expenditure, greater authority to raise revenue would be transferred to the local authority level; alternatively, the amounts of subsidies need to be increased.
  - It is necessary to draw up an integrated strategy or agenda of public investment containing a long-term strategy of public investment with the key participants in the process, with an explanation how this plan fits into the national macroeconomic policies, and the planned level of expenditure per sector and the structure of expenditure within sectors, sources of financing and so on.
  - It is crucial to establish the government treasury with a treasury book and a single treasury account, within the Finance Ministry, and not as part of the Payments Clearing Institute; this will make it possible to unite and control all national revenue and expenditure.
  - It is essential to improve fiscal transparency, which means ensuring a functional classification of extra-budgetary funds, including the privatisation fund, to improve public sector statistics, and to bring the public corporations, agencies and banks within the fold of the regular state budget.
  - It is also crucial to ensure complete records about the situation and structure of the public debt, to cease borrowing on the basis of anticipated revenue from the privatisation of state corporations, to define public debt policy, to pass a public debt law, and in particular to draw up a list of all state guarantees and to define the criteria for the issuing of any further guarantees.
  - A basic recommendation to do with the taxation system is that tax revenue should not be reduced without state expenditure being first cut.
  - The taxation system has to be neutral, meaning that it cannot be allowed to have any effect on the making of economic decisions; the tax base has to be as broad as possible with as few as possible exceptions and privileges, and taxation policy must not be allowed to be used for the implementation of measures of state social, economic and development policies. This means that additional privileges may not be introduced for given branches of the economy, or regions or occupations; on the contrary, there should be a tendency towards the abolition of all existing privileges.
  - The principle of taxing consumption and not savings and investment should be retained.
  - Proportionately to the success attained in reducing government expenditure, the whole of the tax burden should be reduced, the universal rate of VAT reduced, contributions reduced, the amount of personal allowances in the calculation of income tax be re-examined, as should the justification of levying excise on non-alcoholic drinks and small capacity cars.
  - Additional rates of VAT must not be introduced, nor should the profits (corporation) tax be reduced, new taxation privileges must not be brought in, additional rates of income tax should not be introduced, nor should the excise duties on petroleum derivatives, tobacco and alcohol be changed.
  - A quality tax administration is a prerequisite for the successful implementation of the tax system. Here it is necessary to take measures to reduce tax evasion, to determine the administrative and compliance costs of taxation, to pass a law about the taxpayers' rights and a law about fiscal responsibility restricting expenditure at all levels of government.
  - To reduce the grey economy it is more important to do away with the causes than to sanction the consequences, and here the key institutional sphere is the relation between the state and the economy. For this reason it is necessary to improve the laws and regulations, strengthen the independence and competence of the courts, improve the statistics, organisation, efficiency, professionalism and cooperativeness of state bodies, reduce the role of the state in the economy, rationalise public expenditure, improve the quality of the public sector, carry out a reform of the pensions system, make a break with paternalist capitalism, control the privatisation process and strengthen democratic forms of control.
- Improvements in the economics of the public sector will not be achievable without a solution to the problems of retirement and health insurance, the welfare system and the national bureaucracy.

## Introduction

The Institute of Public Finance deals with economic research and analysis concerning various forms of economic, legal and institutional topics important for the sound long-term economic development of the Republic of Croatia.

The general stance of the Institute of Public Finance is to keep discussions at a professional level and avoid current political debate. However, in recent times the economic situation has become so complex that we have become more and more involved in discussions about the duties and responsibilities of experts towards the profession and the country. We have determined, then, that it is essential for us to take a hand and to help to explicate some of the difficult questions that the public in a democratic society ought to understand.

Because of our committed and professional approach, we hope that a reasoned and independent analysis of important current economic questions will help to inform the public and the elected representatives of the public about the effects and possible consequences of alternative policies. We are firmly of the opinion that it is just as important to ask the right questions as to give answers. For this reason, in the text that follows, we shall attempt to give as short as possible a review of the state of affairs, of the problems, and of some possible ways of solving some of the most important questions of public sector economics.

In the first part we shall attempt to ask questions and provide some answers about what the role of the state in the Croatian economy should be. We shall at the same time say what kind of a socialist state we inherited, and how a contemporary state should be created.

The situation in which the public and the private sector encounter creates ideal conditions for corruption to flourish. The Croatian public sector and Budget, because of their exceptional dimensions, are of particular importance in the economy and in society as a whole. In Part 2 we shall give an account of the budgetary process and the fiscal institutions, the optimum level of fiscal decentralisation, the budget at the service of economic growth (of public investment), and fiscal transparency. Since corruption is a consequence of discretionary decision-making and opaque data and policies, it is of particular importance to step up the transparency of the budgetary process.

In Part 3 we will speak of the public debt. In the article the concept of the public debt will be explained, and the special problems of differentiating structural and conjunctural budgetary deficit, state borrowing and monetary policy, the political aspect of the public debt, the problems of state guarantees, the situation and structure of the public debt, and questions of responsibility. Then come proposals and measures in connection with public debt statistics, the sale of national assets, public debt and guarantee issue policies.

In Part 4 we shall analyse the basic questions of the Croatian taxation system. A short description of the Croatian tax system is given, and certain changes relating to the reduction of the overall tax burden are discussed, as well as a reduction in the universal VAT rate and the rate of contributions, the continuance of the principle of taxing consumption and not saving and investment, the retention of the existing rate of corporation [profits] tax, the reduction of the number of tax breaks and so on. Because of the incessant debates on the topic, a special section is devoted to an explanation of why it is best to have a single-rate VAT. Since the implementation of the tax system depends on the quality of the tax administration, a separate section is devoted to the Croatian Tax Administration.

The unofficial economy, particularly in countries with undeveloped or weak democratic and regulatory institutions, is extremely dangerous. The unofficial can outpace the official economy, and entail such consequences as corruption, lobbying, organised crime and lawlessness, which can lead to further social, political and finally economic retrogression. Considering the extent of the unofficial economy in Croatia and the dangers that arise from it, in Part 5 the existing state of affairs of this economy and the reasons for its existence are analysed; proposals for its suppression and for possible research are offered.

Welfare transfers are one of the greatest problems of Croatian public finances. In Part 6, then, we describe the basic problems and offer some possible proposals and lines of research related to a reform of the pensions system, for health insurance and the financing of health care.

Most of the topics we write about in the following pages are of equal importance, and many other topics (the financing, for example, of science, education and culture) that we will not here discuss in detail are also important. The IPF, according to experience and knowledge acquired in preceding ongoing research, is particularly interested in certain aspects of the research that seem to us particularly urgent. These are above all questions of the transparency of public sector economics, particularly of budgetary processes and institutions, the unofficial economy, the tax burden, and reforms of the pensions system.

The texts that follow do reflect the viewpoints and idea that obtain in the IPF. We hope that these stances and ideas will manage make their way to the public, and to its representatives who are charged with making the key decisions. We also hope that they will encourage other people in the profession to put forward their own views, and that this will thus contribute to a reasoned debate, to the starting of further research and, finally, to better solutions being adopted in the economics of the public sector.

## PART ONE

### 1.1 The role of the state in the Croatian economy

#### *The socialist state inherited*

Having broken away from Yugoslavia and started off the transition process, Croatia found itself faced with the complicated problems of having to create an independent sovereign and contemporary state upon foundations inherited from an inefficient socialist state of the federal type. Many of the functions of the state from the previous system had to be changed, and at the same time new institutions had to be created in order to set up a state appropriate to the market economy. Croatia did a lot in the transformation of the state, but it should also be pointed out that over 52% of GDP is still allocated to public spending, and that this proportion has been rising in recent years (see Table 1). That is why there is still such a long and arduous route towards the construction of a different kind of state and government: smaller in extent, and with institutions the nature of which will, to as great an extent as possible, support market processes.

Table 1: The size of the state in Croatia in % of GDP

	1995	1996	1997	1998
Total expenditure of the general consolidated state	48.9	50.7	49.4	52.1

Source: Annual Report of the Ministry of Finance for 1998

As stated above, in contemporary economics literature it is generally considered that the macroeconomic stability and openness of a country are necessary, but not the sufficient, conditions to build a market economy, ensure sustainable growth, and thus attain a high degree of prosperity among the population. It is also necessary to adjust governmental institutions to market conditions. As well as having to address its fundamental tasks in the fields of the protection of property rights, basic education, health care, the infrastructure, the maintenance of law and order, the state plays a key role in the politics of regulation, social protection and structural reforms. The state needs to be smaller as a whole, while in certain segments it needs to be different, thus adjusting its functions to the needs of the market economy. The fundamental principle and basic point of departure in the reform of government needs to be that the state needs not take on those matters that the market does better, but should step in where the market falls down. To as great an extent as possible the state has to retire from any entrepreneurial role, and create by its measures an environment for the continued development of private firms prepared to innovate and to take on commercial risks.

#### *The creation of a contemporary state*

In order to achieve the objective of creating a smaller, different and more effective state, reform in Croatia has to move in three directions: 1) the development of institutions appropriate for a market economy, 2) as-

sistance in the development of a new economic structure and 3) the application of horizontal measures of government intervention.

(1) One of the main directions of the reform of government in the Croatian economy has to be the development of a system of institutions the purpose of which is the supervision and regulation of the course of the market, and the protection of individuals who have been left without means by market competition. Institutional reform includes:

- The adjustment of institutions ensuring the country's security and implementing law and order, one of the basic functions of the state, to new, peacetime conditions;
- The development of a stable and transparent legal system with a set of regulations that in a predictable and effective way make possible the maintenance of financial discipline, the management of affairs, the protection of the creditor, and the definition of property rights. This will in turn ensure the security of contracts, and a quick and transparent exit from the market of ineffective banks and companies. Changes in the legal system can be achieved by investing in the education of new judges, the retraining of existing personnel, the development of contemporary administrative structures, the updating of equipment, and pay rises for the judiciary;
- Reform of the state institutions into market-friendly, capable and independent institutions. Capable, educated and motivated civil servants make a capable state. A state, or government, is independent to the extent that it does not become subject to the influence of various interest groups but makes its decisions independently and responsibly. Transparency of state policy, and clarity, speed and impartiality of administrative procedures provide security to enterprises in both current operations and in planning for the future. Greater efficiency of state functioning can be achieved through the development of already existent market-compatible mechanisms (public auctions, contracting out certain state functions to the private sector, for example), reduction in the number of and change in the structure of public servants, the development of an incentive system, staff training and further updating of equipment;
- The need for an incorruptible state administration. The creation of stable institutions not subject to constant changes, the development of a system of unambiguous laws, an enhancement of the motivation of civil servants through a reform in the incentives system, raising the morality of work through an exemplary system of penalising the immoral are just some of the ways towards the reduction of corruption in the state bureaucracy;
- Building up a social security system in which assistance to those whose welfare is at risk and to the unemployed will be directed by transfers the

amount of which will be determined according to the current income and assets of the individual or the family, and not by a selective tax policy. This will ensure transparency in the granting of welfare benefits and avoid linearity of measures, with help really getting to those who need it most. For this purpose it is necessary to build up a reliable, comprehensive and well-protected information system for monitoring income and assets, and their distribution among individual groups of the populace;

- The construction of a reliable and up-dated statistical system in a clearly defined number of institutions, which will ensure the base for the successful management of national economic policy;

- Constant collaboration and dialogue of all the main participants in the economic process, which will greatly facilitate the course of reform. A social partnership between the government, the unions and the employers is a guarantee that the reforms will be carried out successfully.

(2) Apart from that, the state has to help in the reallocation of resources for the sake of creating a new, competitive economic structure. For this purpose it should:

- Continue the privatisation, and reform the public enterprises that will remain state owned. All the public enterprises should be privatised as soon as possible, or the parts of them that can function in the market. In the other public enterprises the state, as owner, has to step up control over the management, and encourage them to be exposed to the laws of the market;

- Make an impact on the creation of new market structures through the regulation of monopolies and an anti-monopoly policy, as well as the regulation of takeovers and mergers. Since a more powerful development of the financial markets can be expected to occur, it is particularly important to stress the regulation of the financial sector, which includes the banks, the capital market, and the insurance companies;

- Abandon the policy of using soft budgetary constraint with respect to troubled companies, which leads to opaque direct or indirect subsidies (for example, bailing out companies through exemptions from payment of taxes or contributions which expands the moral hazard);

- Define a clear policy with respect to loss-making industries. In the world at large, the policy of subsidising production has mainly been abandoned, and a transition has occurred to subsidising the costs of their getting out of the market. It is important to study and work up this approach, because in the coming period in Croatia there will

be bankruptcies of a considerable number of ineffective companies;

- Set up retraining centres for workers getting out of industries that are closing down. In particular, facilitate the acquisition of entrepreneurial, managerial and marketing capacities in order to develop the new entrepreneurial spirit necessary for the launching of new product lines;

- Create a network of agencies for the assistance of small and medium sized companies. Such agencies would disseminate information about loan facilities and financial markets, about new technology, training opportunities, export markets and the like. This kind of policy would reduce the barriers in the way of SME getting into the market, for they too would have at their disposal the kind of information that large corporations can easily come by.

(3) Through measures of horizontal and not selective policy the state ought to improve the working of the market so as to raise the quality of key economic inputs: of the economic infrastructure, of labour and capital, R & D. Today, in most countries the prevailing opinion is that a market that has grown on such bases will ensure the greatest possible efficiency of resource allocation and lead to economic growth. A market-friendly state should place the accent on the application of horizontal economic measures, which mainly relate to:

- State investment in the economic infrastructure, especially in the transportation and telecommunications networks, and in power supply, but only in those parts where the market has fallen down;

- The building up of a contemporary education system capable of equipping human resources with the kind of knowledge that will enable flexibility in the workplace and mobility in the labour market, and develop a sense of personal responsibility. This will gradually reform the inherited way of thinking about the state as ensuring total security for individuals, and will create the bases for the development of the entrepreneurial spirit. The facilities for continuing education have to be provided, which will make sure that the capabilities and resourcefulness of the working population are maintained in conditions of rapid developments in technology on the one hand, and postponement of the retirement age on the other. It is necessary to work out models for educating a critical mass of students abroad to develop a system to transfer know-how to our economy. It is particularly important to highlight the need for the acquisition of managerial skills, which are today in short supply at all levels of the state, as well as in companies and banks.

- The creation of new forms of support for research and development, the encouragement of the dissemination of the state of the art in technology,

stepping up international collaboration in science and the professions, and ensuring technology transfer. Here it is particularly important to stress the stimulation of direct foreign investment, which will facilitate the rapid transfer of know-how and technology;

- The implementation of an environmental protection policy through the development of ecologically acceptable industries, the introduction of a green tax, and the regulation of existing polluters.

The development of market institutions, help in the reallocation of resources so as to create a competitive economic structure, the avoidance of selective measures, and the application of horizontal measures to improve the quality of the economic infrastructure represent the basic guidelines along which the development of the state in Croatia should go at the present time. This will be a lengthy and painful process requiring a lot of persistence and consistency; it is, however, the only one that in the long run can lead to a state that is smaller in extent and more qualitative in its operations.

## PART TWO

### 2.1 The Budgetary process and budgetary institutions

#### *The basics*

The budgetary process is the system of the main rules (formal and informal) that enable the executive to make decisions that lead to the preparation of the Budget, its proposal and acceptance in parliament, and finally to the execution of the Budget. The budgetary process is the means by which the state defines the overall plan of the Budget (the planned level of revenue and expenditure), and within which decisions are made about the allocation of resources. Through the allocation of resources, the budgetary process is a useful tool for ensuring the effective administration of the state.

There are three phases in the budgetary process: 1) the preparation of the Budget proposal, 2) presenting the Budget to parliament and approval, and 3) the execution (implementation, supervision and control) of the Budget.

The fiscal (budgetary) institutions are the key to the successful functioning of the budgetary process. Only effective functioning of all the institutions (ministry of finance, government, parliament, state auditing) in the budgetary process make possible the implementation of the planned fiscal policy.

#### *The situation*

In 1994, Croatia passed the Budget Law (OG 92/94). According to this law, the Budget is defined as an es-

timate of the annual revenues and receipts, and the determined amount of expenditures and other payments made by the state (and local government units) for all budgetary beneficiaries and approved by parliament. Budgetary beneficiaries are ministries and other bodies of the administration, bodies of the government, and other beneficiaries financed out of the national Budget. The Law states the procedures for the planning of, manner of drawing up, passing and executing the national Budget, borrowing and the national debt, and supervision of the Budget.

Almost five years since this Law was passed and started to be implemented. In this period, there have been many changes that call for an analysis of the Budget, and in particular of the budgetary process. We will cite just a few of the most important items:

- Since 1994, national or public sector spending has substantially increased its share of GDP, and in 1998 public sector expenditure made up 52% of GDP. Croatia actually has the greatest public sector expenditure in terms of percentage of GDP of any of the countries in transition.
- The proportion of the national Budget in GDP has also increased.
- There are no systematic data about the level of the public debt, nor are there any restrictions on the deficit or the national debt.
- In the last five years the Budget has been rebalanced as many as three times (1995, 1998, 1999).
- No prediction of the Budget for a three or four year period has ever been made to determine the position of the Budget and its relation with key macroeconomic indicators.
- The system of internal and budgetary control is weak and ineffective.
- Not all actions for the establishment of a state treasury system have not been taken, nor for the transition to all payments being made from the single treasury account.
- Lack of Fiscal discipline.

These drawbacks constitute very great limitations in the implementation and realisation of a sound fiscal policy. The reasons for the shortcomings that can be seen directly in the Budget should be sought in the weak budgetary process and the feeble functioning of institutions that are directly involved in the process of preparing, proposing and executing (implementation, supervision and control) of the Budget.

#### *The Reasons*

**Preparation of the Budget.** The Ministry of Finance (MF) is charged with the preparation of the Budget, which starts with the preparation for the proposal for the fiscal policy in the coming year, within the outlines of the proposal for the three-year fiscal policy. This proposal should include the drawing up of macroeconomic and fiscal predictions. The drawing up of macroeconomic predictions relates to the establishment of a three-year projection of the trends in basic macroeconomic magnitudes, and the establishment

and projection of basic budgetary magnitudes, on the basis of which the fiscal strategy for the three-year period is then defined.

Back in 1998, the MF promoted its "Principles of Fiscal Policy for 1998-2000", in which, as well as the trends in the key budgetary magnitudes, the macro-economic framework for fiscal policy was also drawn in. This projection was quickly discarded for its unreal estimates, but no new projection was ever made.

In budgetary planning praxis to date great difficulties have been presented by the unrealistic plans of budgetary beneficiaries and failure to stick to the prescribed accounting plan of the Budget. This kind of procedure has made it very difficult for the Budget Preparation Office to make more realistic proposals for the expenditures of the Budget. The problem is in weak budgetary control, and failure to carry out measures aimed at boosting fiscal discipline. An additional problem is to be found in a weak information and control framework, which aggravates the situation in the overall management of public finances, including budgetary planning, as well as supervision and implementation.

*The government*, at the recommendation of the MF, proposes the fiscal policy and defines the strategy of the national Budget, and lays down proposals for allocating budgetary resources in line with the established objectives of economic, fiscal and budgetary policy for the given fiscal year. In practice to date, one very great limitation in the implementation of the fiscal and budgetary policies is the way extremely unrealistic magnitudes of economic growth indicators, or of GDP growth, have been accepted. An overrated GDP easily creates the basis for an increase in state expenditures for programmes and objectives that the real level of revenue will not support. Such procedures militate against the implementation of programmes, and in many cases the government's manoeuvring space is restricted. The government has usually found a way out in home or foreign borrowing, and the issuing of guarantees to budgetary and private firms.

**Approval or passing of the budget.** The budgetary proposal sent by the government to the parliament should go through detailed analysis in the Finance and Budget Committee, and in other parliamentary committees and bodies. Only after an analysis of the budget in the committees can it go for debate in both houses. The parliament analyses the proposal of the national Budget, and after debates in both houses (of Representatives and of Counties) it will adopt the national Budget and agree to the budgets of the extra-budgetary funds.

Practice to date shows that parliament has never debated the consolidated general government Budget. This fact to some extent explains the lack of debate about the overall deficit of the government and the lack of any restriction to this deficit. The reason for this state of affairs can be found in the weak proposals of the Budget. The Budget is proposed to the parlia-

ment with unrealistic assumptions (forecasts) about revenue, and as a result, the budgetary expenditures to a very large degree outstrip the available sources of budgetary resources. During the year this leads to a reduction of expenditure, partially through a rebalancing of the Budget, forcible collection of claims and through an accumulation of unpaid bills. Since the limits of the public debt and the deficit are not defined, the Budget turns to month-by-month deficit financing of the beneficiaries of the Budget.

**Execution (implementation, supervision and control) of the Budget.** *The organisation of a state treasury is foreseen in the Ministry of Finance. The basic responsibility of the treasury is to manage the state's money and the public debt efficiently. The state treasury system consists of three linked administrations or departments: for the execution of the national Budget, for national accountancy, and for managing cash and the public debt.*

At present, the MF still does not make all its payments from the single treasury account that it has at the CNB. It is necessary to close down all the other accounts that the Budget still has at commercial banks. Since 1997, payments have been made from the single account for some budgetary beneficiaries, with the provision that during 1999 it was expected that all other budgetary beneficiaries would be brought into the system. One of the problems in bringing the treasury project to a conclusion is the unsettled question of the computer linkage of the three agencies mentioned into a single unit.

*The national Budget execution department*, apart from being supposed to pay out money via the single account within the framework of the budgetary position to suppliers of the MF and the consuming agencies, has an important role in the working out of financial inflow and outflow during the year. The budget control department should have an important position within this administration.

*The national accountancy department* records state transactions on the cash principle. Only if transactions were made according to the accrual principle would an integrated picture of the situation of the national finances be obtained. The problem inheres in the constant changes in the accounting monitoring of the positions and items of the Budget. For this reason it is difficult to compare the amounts of the resources of individual positions of the Budget in different years.

*The cash and public debt management department* should run schedules of debts, loans made and guarantees issued. It has to have information at its disposal about the forms of loans and the kinds of security instruments for the repayment of loans. At the moment there is no overall picture of home and foreign borrowing, and plans shown for repayments of loans up to 2010 are not shown in terms of maturity dates. A particular problem is found in the monitoring of the amounts of the guarantees issued. The ad-



ministration keeps its eye on the state of cash in the Budget account, and on the basis of this information issues treasury bills. It is questionable to what extent there is a full insight into the state of the resources of the Budget when part of the money is kept in the Budget's accounts at commercial banks.

*Supervision and control of the Budget.* The basic task of MF budgetary and internal supervision is control of the correct usage of resources for the entire country. Budgetary and internal supervision were not organised even during 1998 and 1999, and there is no sign of operations within the MF. It is also a problem that there is no internal supervision in the other beneficiaries of the national Budget. And so accordingly no special working relations have been set up between the institutions of national auditing and the supervisory institutions.

*The state auditing office* was set up to supervise and control the Budget and budgetary beneficiaries. It regularly publishes reports about audits it has done and appends them to parliamentary Budget debates. Although of very high quality, the findings of the audits to date about shortcomings in the budgetary process have not been adequately applied in practice.

### *Proposals*

The Budget should show the state of the national finances and provide basic information about the measures that have to be taken in order to carry out a successful fiscal policy. Nevertheless, the Budget is the result of the budgetary process, in which the key role is played by the actions and procedures of the budgetary institutions. Improvements in the budgetary process then depend upon institutional changes. This is the key to the understanding of the challenges that exist with respect to the improvement of the management of public expenditure in Croatia. Improvement of the management of public expenditure requires institutional reform, which means consistent application of existing laws to do with the Budget, and improvement of the work of the budgetary institutions. Improvements in the budgetary process are impossible if efficient supervision and implementation mechanisms are neglected.

To improve the budgetary process, it is necessary to:

- Strengthen the internal links in the budgetary process, with an emphasis on cooperation among departments within ministries and other beneficiaries, and ensure the exchange and distribution of information (too often considered personal property) that leads to an integrated approach in the proposal of fiscal policy and makes the taking of correct decisions possible.
- Strengthen the links among the institutions that take part in the budgetary process system (from proposing to executing the Budget), and not just among the central ministries. Provide flexible and simple procedures and the consistent appli-

cation of existing laws related to the Budget and the state treasury system.

- The Finance Ministry has to facilitate transparency in all the fiscal operations of the state. For this purpose it has to aim at a complete view of all the transactions directly connected with the Budget.
- Independent research institutions should have a greater role in the evaluation and review of political decisions that might have an impact on the future fiscal position.
- The country needs well developed budgetary institutions run by competent individuals guided by correct inputs. The aims of individuals who manage public institutions must not differ from the objectives of the institutions, and these, in turn, have to be in accord with the public interest. Such institutions do not spring up over night. They have to be created and keep on being reformed.
- The definition and implementation of a public expenditure policy have to be founded on an economic analysis and estimate of the effects of individual categories of expenditure and of public expenditure as a whole.
- Increase supervision and control of the Budget. The parliamentary finance and Budget committee has to have the resources and the qualified personnel to estimate the Budget proposals that the government sends down to the parliament. The professional personnel of the finance and Budget committee have to be capable of looking critically at the estimates of the government, and in the event of there being a great disproportion between revenue and expenditure and an ineffective distribution of expenditure, will have to send the proposal of the Budget back to the government, with its criticisms, for review.
- Conclude the organisation of the state treasury and ensure that payments are made from the single account of the state treasury kept at the CNB.

## **2.2 The optimum level of fiscal decentralisation**

### *Financing local government units in the RC*

In 1994 local government and its territorial units were reorganised, and there was a new manner of financial local government units; certain drawbacks have been revealed since this started to be implemented. We shall state some of the more important problems.

First, constant territorial changes, and the excessive number of municipalities, have additionally slowed down the acquisition of data about the real financial

situation, that is to what extent revenue determined by the Local Government Finance Law (OG 117/93) has been collected so that the amount needed in the fiscal equalisation system can be determined.

Second, most local government units newly-created in 1994 did not have a balance sheet of their assets and did not know what they had at their disposal, or what the value of their assets was.

Third, the areas of the Republic of Croatia show a varying demographic and economic picture. Constant changes in the size of the area of local units entail consideration not only of the historical but also of economic, political and demographic features of a given area. The wealth or poverty of a local unit derived from an uneven distribution of natural and economic sources continues to have an impact on the local government financing system. An estimate of these inequalities determines the decision about the best assignment of grants to local government units that cannot meet even the minimum requirements of the populace in their areas.

Fourth, the importance and development of the tourist sector has contributed still further to the urgency of the question of the development of the islands and the manner in which they are financed. In a selective approach to the financing of the poorest local units (including the islands) grants from the central government remain. However, there is still the practical problem of how to define the criteria for the allocation of grants.

Fifth, the participation of central government grants in the financing of the total public expenditure of local government determines the degree of dependence of local on central government. The need has arisen for the determination of the optimum degree of fiscal decentralisation.

Sixth, at the local government level, financial surpluses do arise. The existence of surpluses shows that there is an unequal level of the meeting of public needs. On the one hand great needs, and on the other hands surpluses; this raises the question of the suitability of the system with which local government is financed.

Seventh, the revenue of local government is not realistically planned and it is often found that in the accounts books not all revenue and expenditure have been recorded, and that prompt collection of revenue has not occurred. Some expenditure turns out to be greater than what was planned, and some expenditure is made without having been planned at all. Some budgetary resources are used for purposes they were not meant for.

It is clear that within the local government financing system there is a problem of deciding on the financial resources necessary for a given local gov-

ernment unit for it to be able to fulfil the tasks for which it has been made responsible.

*The financial effects of the new system of financing local government units*

Since the new system for financing local government was introduced in Croatia, a disproportion has been observed in the fiscal capacities of the cities and the counties and the responsibilities that have been laid down to provide for public needs at a given local level. That is, a large part of the responsibility for the provision of public services has been transferred to the counties, which are finding it hard to carry out the functions laid down by the law. In the table below, we can look at the distribution of revenue among the local government units.

Table Income per local government units in %

	Counties	Municipalities	Cities	Total
1995	12.25	18.90	68.84	100
1996	11.87	18.83	69.29	100
1997	9.80	14.08	76.11	100
1998*	9.25	15.70	75.05	100

\* data for 1998 relate to the plan of the Budget  
Source: Ministry of Finance, RC, 1999

The financial position of the counties and cities is considerably better and they even find surpluses occurring in their budgets. For this reason it is essential to change the system through which local government is financed and ensure an enhanced fiscal capacity for the counties. It is crucial to facilitate an increased tax sharing, primarily in income tax and in real estate sales tax.

*Fiscal (de)centralisation*

In small states the proportion taken by government in GDP is large, and this share tends to try to maintain itself. In Croatia too, the proportion of GDP taken by the state is growing.

Table Expenditure of general and local government as % of GDP

	1995	1996	1997	1998
Consolidated general government	47.74	50.65	50.46	52.17
Local government	4.46	6.05	6.76	6.93

Source: Ministry of Finance, RC, 1998

The expenditure of general government accounted for 47% of GDP in 1994, increased in the next two years, and in 1998 held fast at the level of about 52%. The share of local government rose from about 4.5% in 1995 to almost 7% of GDP in 1998. The situation with revenue is similar.

Is this level of revenue and expenditure for Croatian local government units enough to finance their increased responsibilities? Since 1997 the central government has transferred numerous responsibilities to

local government, for the financing of health care, social services, the maintenance and building of roads, while revenue has stayed at a low level. In such conditions it can be expected that there should be a developed system of grants to lower levels of government, so that the uneven sources of income of local units should be made up. Certainly, local government should be able to have a large share of revenue from tax sharing. All this is to increase the fiscal capacity of local government.

The degree of centralisation of any system is measured by the share of the expenditures of central government in total direct expenditure. The use of this criterion confirms the statement that central government has the lion's share in the total expenditure.

Table: Distribution of total national spending in Croatia according to level of government in individual years in %

	Central government	Counties	Municipalities and cities	Total	Central government	Lower level government
1995	87.09	1.56	14.45	100	87.09	12.91
1996	83.96	1.96	14.08	100	83.96	16.04
1997	83.62	1.62	14.76	100	83.62	17.38
1998	82.14	1.53	16.23	100	82.14	17.86

Source: Ministry of Finance, RC, 1999

By far the most is spent at the level of the central government. For this reason in the coming period it will be necessary to consider laying down the optimum degree of fiscal decentralisation, in which, in addition to considerable responsibilities for financing certain expenditures, greater authority to gather revenue should be devolved upon local government; alternatively, their subsidies or grants should be increased. In spite of all this, the choice of the appropriate degree of fiscal decentralisation depends upon the central government and on the extent to which it is prepared to give local government some autonomy in gathering the resources that are used to finance local public services. The question of fiscal decentralisation is not, after all, merely of an economic nature.

## 2.3 The Budget in function of economic growth - public investment

### *The bases of public investment*

Capital expenditure, or public investment, is a productive expenditure, and represents a powerful tool with which the state can stimulate economic growth. Public investment (capital expenditure) consists of investment in private sector production and contributes to the growth of the economy in the long run.

An important contribution to the understanding of the role of fiscal policy in long term growth was made by Barro (1990), in whose model growth is stimulated by state actions. A positive link between state expenditure and rate of growth, in this model, derives from the impact of government spending on private production. It is shown that an increase in productive public expenditure (investment in private production)

increases the marginal product of private capital, which has a positive effect on the rate of growth. However, since apart from productive (capital) expenditure, the government also finances a whole number of unproductive programmes that do not represent any investment in private production, the resultant rate of growth is lower than that achieved when all the expenditures are productive. The conclusions reached by Barro emphasise the need to distinguish productive from non-productive expenditure.

Non-productive expenditure does not constitute investment in private production. It consists of transfers (apart from expenditure on education), expenditures for defence, interest payments, wages in the civil service (especially when there is over-employment) and so on.

The very procedure of measuring the impact of non-productive expenditure on the rate of economic growth is a topic of constant theoretical discussion. For this reason it is necessary to use the classification system of Government Financial Statistics, in which most non-productive expenditure is classified as current expenditure.

Particular attention is merited by that part of state capital expenditure that is used in the process of public investment. Public investment here means the total level of capital expenditure of the state including capital expenditure of the Budget, the extra-budgetary funds and local government units.

For that reason it is necessary to make an analysis of capital expenditure and determine its impact on economic growth. In every state it is essential to make sure of the kind of classification of the Budget that will enable an analysis and monitoring of public (current and capital) expenditure. This is particularly essential with attempts to determine the level of public investment and its impact on economic growth.

### *The situation with respect public investment in the RC*

The article "Public Investment in Croatia" by Anto Bajo and Katarina Ott published in *Financial Practice 1* in 1999 can serve as a starting point for an analysis of the state of public investments in Croatia. In this analysis of public investment there was an attempt to adjust the statistical methods of the public sector in Croatia to the GFS practices used in most countries in the developed world.

The analysis of public investment shows that the main capital expenditure is financed at the level of central government, and that funds from the central government Budget are crucial in the financing of capital projects. In practice, funds for financing capital projects are mainly given from the central Budget to the appropriate ministries. The competent ministries assign funds for local projects, usually in line with some key and usually according to priorities. Funds can be made available via the Croatian Bank for Reconstruc-

tion and Development (CBRD) or the commercial banks.

In the period 1994-1997 capital expenditure of the state mainly related to reconstruction of the infrastructure damaged during the war, particularly houses, roads, water mains and health care infrastructure. Nevertheless, data that reveal the sector structure of public investment show a emphasis on "development oriented" capital expenditure. Public expenditure for "reconstruction" came to a head in 1996 when it amounted to 33%, falling back to 20% of all public investment in 1998. It should be said that the ministries themselves do the categorising of their projects, and the distinction of expenditure according to "reconstruction" and "development" is not entirely reliable.

Looking at the sector structure of public investment in the period from 1994 to 1998, it is easily seen that in 1994 the biggest category of public investment was "public administration building" (including buildings, equipment, maintenance, and border crossings). In 1995-1997, public investment for "reconstruction" was the largest category. However, in the Budget for 1998, investment in public administration buildings was once again the biggest individual category of public investment (21%). The third biggest category was spending on roads, which had, however, fallen from their maximum 19% in the 1996 Budget to 14% in that for 1998. After them came investment in the water industry and residential buildings for disabled veterans.

In the public investment system, attention is merited by the role of CBRD loans in the financing of public investment. In a certain sense, CBRD loans represent an additional budgetary financing of capital projects. The CBRD obtains annual injections of funds from the Budget, and most of the lending activities of the bank go on for the state and should not be taken to imply any independent investment decisions of this financial institution. Data from the annual reports show that more than 90% of the loans of the CBRD in the first three years of its operations (1993 - 1995) were spent on the reconstruction programme (mainly the water industry, flats and so on). After this, the CBRD started to make loans on behalf of and at the expense of the MF (about 10% of CBRD loans in 1995, but more than 50% in 1996), while the main beneficiaries of CBRD loans were state-owned enterprises or enterprises managed by the state, particularly in the areas of the water industry, construction and electricity generation. In 1996, 35% of the funds of the CBRD went to the tourist sector. Since 1996, the CBRD has been lending increasingly to private enterprises.

*The position of local government in the financing of public investment.* The low level of local government revenue is a big barrier to its doing anything to take a more active role in the financing of public investment. The fiscal capacity of, for example, most of the counties, is below average. Because of this, capital proj-

ects at the local level are financed at the central level, the MF and other competent ministries. It is impossible to give any estimate of the share of foreign funds in the financing of capital projects at local government level, because there are no systematic data. It is also impossible to give any account of spending broken down into sectors at a local level. Unfortunately there is no appropriate collaboration in the unification and systematisation of data among local government units (communes and cities) and the finance departments of the counties.

### *Reasons*

At the moment it is difficult to get an overall view of the level and structure of public investment in Croatia. This state of affairs is the result of the lack of existence of an overall strategy or programme for public investment. Such a programme ought to contain: 1. a long-term strategy for public investing with key participants (institutions) in the process of public investment, 2. an explanation of how a public investment programme fits in with the aims of the macroeconomic policy of the country and 3. a planned level of expenditure per sector and the structure of expenditures within a sector, sources of financing and so on. A programme of public investment should include all projects that have a direct impact on the national Budget, from which capital projects are financed.

A key precondition for any proposals for a programme of public investment is the efficient functioning of the institutions involved in the process of public investment and a clear division of roles and authorities among those participating in that process. Practice to date in Croatia relating to public investment has shown great weaknesses in the institutional framework. Some problems in the institutional framework need highlighting. In order, then, they are as follows.

*The state treasury.* Budgetary funds, particularly on the expenditure side, are dissipated in various ways. The reason is the absence of any efficient supervision of the movements in funds on the revenue and on the expenditure side of the Budget. The state treasury, as organisational unit responsible for the preparation, execution and control of the national Budget, the management of funds and the national accounting system, should be located within the MF. This means the establishment of a state treasury with a single account book and a single account, which makes possible direct allocation of resources to beneficiaries.

*A consolidated national balance sheet.* The resources of public companies and agencies and the CBRD should be included into the consolidated Budget. This also means the integration of activities carried out by the Payments Clearing Institute and the Ministry of Finance, taking over the PCI database, and leaving the PCI the sole agency for payments clearing. This would make possible a more transparent and a cheaper control of the state treasury and an evaluation of the financial activities of the state sector. In some

more detailed research it would be very interesting to analyse the annual reports of the PCI and determine what its real position in the public sector is.

*Local finances.* There is no fairly detailed analysis of public investment at the local government level. Several cases of public investment at the local level show that it is possible to finance investment locally. It would be worth taking a closer look at the real circumstances, needs and possibilities of local government in the financing of capital projects from their own resources. Local governments should have separate budgets for capital and current expenditure. This would make it possible to have a more transparent review of resources for capital investment and a more economical approach to investment, because there would be less administration in the ministries.

*Allocation of funds via the CBRD.* Funds for capital projects derive from the central government's Budget and from international financial institutions. There is a special part of the national Budget for the financing of capital expenditure. In it, there is a more detailed account of the funds needed to be allocated to individual beneficiaries. Since 1995 a considerable amount of the resources for the financing of capital projects has been channelled through the CBRD. It would be useful to explain the role of Ministry of Reconstruction and Development (MRD), the relation between that ministry and CBRD, and explain the ways of and criteria for allocating resources to individual beneficiaries. This would take for granted a serious analysis of cost benefits, and an evaluation of the investment. It is impossible to give systematic data about capital expenditure financed via the Croatian Bank for Reconstruction and Development and the MRD.

*Financing reconstruction against financing development.* As one of the consequences of the war, most of the resources for capital projects were put into reconstruction, and only a smaller part into growth (into tourism since 1996, and into small and medium size enterprises). Most of the funds were put into the public enterprises (the water industry, road building and electricity generation and distribution), but it is not always easy to distinguish reconstruction from development. It would be a good idea to make a firmer distinction between the two and decide what is an appropriate division of funds between them. Apart from that, there are grounds for concern in the large share of non-productive investment in administration buildings and equipment (about 20% of all public investment on average), which squeezes out the very necessary greater investment in production.

*Guarantees.* The existence of a wide selection of state guarantees leads to the need for answers to several questions: (1) What kind of guarantees ought to figure in the national Budget? (2) Is there a single list of all guarantees issued in the last few years? (3) In that list, is it possible to see what guarantees have expired, and which are still valid? (4) Is the total amount of guarantees issued added to the total indebtedness of

the country and should they be counted as a part of the public debt?

*The roles of agencies.* The position of the Croatian guarantees agency (CGA) and other agencies in the public sector is unclear. It would seem that their assets are part of the Budget (their equipment is financed from the Budget), but the situation with respect to their obligations is not entirely unambiguous. It should be evident whether the items of their financial reports are in balance, and who controls their items in the Budget. It is absolutely essential for there to be transparent data about whether the state has paid its part into the CGA or not, whether the CGA guarantees are included in the list of total national obligations, whether they are included in the public debt, home or foreign and so on.

*Proposals:*

- Re-examine the role of institutions that take part in the process of public investment (Payments Clearing Institute, state agencies and public enterprises, local government, CBRD and so on).
- Make an analysis of and separate the financing of reconstruction and development.
- Evaluate and limit the size of state guarantees issued.
- Include foreign sources of financing in the analyses of public investment.
- Apply a cost benefit analysis, and ensure a transparent process of evaluating projects in the budgetary procedure.
- Define criteria for determining the position of all the public enterprises and their links with the Budget.
- Improve cooperation inside the overall capital financing system (reinvestigate the spending of the relevant ministries).
- Step up the financing of development projects and restrict funds directed to buildings and equipment for the administration.
- Facilitate an integrated analysis of all public expenditure.
- Unify the programme of public investment and coordinate the evaluation of investment projects.

## 2.4 Fiscal transparency

### *Basics*

A transparent budgetary process ensures clear information about all aspects of fiscal policy. A key role in transparency is played by actions and procedures oriented to informing parliament and the public precisely about the intentions of the fiscal policy, about the budgetary accounts and about the projections of the Budget. A budget that includes numbers of separate accounts and that does not manage to consolidate all fiscal activities in the bottom line is not transparent. A budget that is easily available and intelligible to the public and those who take part in the decision-making process, and which displays consolidated information, is transparent.

The IMF has prescribed minimum standards for transparency in the Budget and in procedures in the budgetary process. We will highlight the basic actions and procedures that the state should undertake in the preparation and execution of the Budget.

When preparing the Budget, the Finance Ministry should include within the Budget plan: 1) the aims of fiscal policy and their feasibility 2) fiscal regulations and 3) the macroeconomic framework.

Annual expectations have to be shown in the Budget, and there should be a clear report about the intentions of the government's fiscal policy, the consequences of the current fiscal policy, and the sustainability of fiscal policy over the medium and long term.

The central government should regularly publish data about the level and structure of debts and the financial assets that represents the amount of the net debt. Reports about the debt should contain information about the size of the central government debt, including loans and bonds issued.

The annual Budget should be shown within an intelligible and appropriate quantitative macroeconomic framework. The minimum standard requires that a report about the Budget be made in the medium term macroeconomic framework, including the basic presumptions for the macroeconomic predictions on which the Budget is founded.

The execution and supervision of the Budget is based on: 1) the accounting system and 2) auditing (internal and external) of the Budget account. An intelligible and integrated accounting system should be set up, one that is based on a good control system. An efficient system of state accountancy should ensure information adequate for estimation of the amounts of overdue accounts, payments or revenue. Parliament and the public should be able to have high quality fiscal data and information provided by the state auditing establishment.

*The lack of transparency* or the weak transparency of the Budget may increase the electorate's confusion

and reduce politicians' interest in being fiscally accountable. In practice various tricks are used to make an impact on the attitudes of the taxpayer. These include: 1) Overestimating the expected economic growth, so that take revenue is also overestimated, and the size of the expenditure is underestimated. At the end of the fiscal year the unexpected fiscal deficit is attributed to unforeseen macroeconomic events for which the state can claim not to be responsible. 2) Keeping various items outside the Budget. Budgetary resources are used by institutions that are not included in the state Budget. 3) Strategic use of a long-term projections. Publishing a three-year plan for fiscal adjustment within which all the difficult measures in fiscal policies have to be taken, politicians can buy time without any intention of actually carrying out the policy sketched out.

### *The current state of fiscal transparency in the RC*

In the public finance practice of the RC to date, shortcomings in the budgetary process have been reflected directly in lack of fiscal transparency. Feeble control of the Budget, the absence of a macroeconomic framework and of realistic planning are connected with weak fiscal responsibility of those in charge of economic and, in particular, fiscal policy. These factors also put a limit on the making of correct decisions about the allocation of budgetary resources. The situation with respect to fiscal (budgetary) transparency is described in the next section.

*Planning the Budget.* When the Budget is being planned, the annual expectations from the macroeconomic environment are only denoted in outlines, as is the report about the intentions of fiscal policy. There is no evaluation of the effect of the existing fiscal policy, nor the sustainability of this policy from the mid to long term. There is no midterm budgetary framework in which it would be possible to estimate and predict trends of key budgetary aggregates over a period of 2 to 3 years. In Croatia there is not even any formal methodology for macroeconomic prediction. It is very difficult to talk of any use of advanced, sophisticated quantitative models, particularly because of the constant economic changes and other limitations.

In the annual Budget the main fiscal risks are not stated nor are they put in figures so that their impact on the realisation and implementation of the Budget can be determined (for instance, the impact of a growth in budgetary deficit of 1% on growth of GDP, interest rates, the assumed exchange rate, changes in the wages of public sector employees, the number of beneficiaries of welfare programmes, the effect on financial restructuring, the bailing out of the banks, the realisation of the Budget, and so on).

There are no publicly available and complete sources of information about expenditure shown according to functional and economic classifications. Expenditure is classified and published only according to administrative categories. There is the provision of neither a

report on or classification of expenditure in terms of programmes, sub-programmes or categories of activity. This programme classification should be an appendix to the traditional administrative classification.

*The execution of the Budget.* The MF only occasionally publishes just parts of the details about the borrowings of the country. The problem inheres in the lack of any legislative framework to regulate the scope of the public debt. There are also no complete data about state guarantees (how many have been issued, the amount, maturity, and to what extent they are a threat to the expansion of the public debt).

It is a question to what extent the state of the overall balance sheet in official statistics is realistically presented, when one knows that they do not take into account obligations brought forward, obligations relating to guarantees issued (from the agencies, from the extra-budgetary funds, the CBRD) and to what extent the obligations of the other public financial corporations and non-financial institutions affect the overall deficit of the public sector. An chart of accounting has been prescribed for the national Budget and for beneficiaries of the national Budget. The transactions of the state are recorded on the cash basis principle. Only if transaction were recorded according to the accrual principle would a real picture of the state of the national finances be obtained.

### *Recommendations*

Increasing the degree of fiscal transparency is difficult to achieve. Experts give three possibilities for improving the transparency of the Budget. 1. The legal approach, so-called, which emphasises the need for a greater number of rules and laws to regulate the preparation, organisation and execution of the Budget. This approach might have opposite results if complex rules and procedures are brought in that constitute the basis for additional lack of transparency in budgetary procedures. 2. Giving political independence to the public body responsible for the transparency, precision and projection (forecasting) of the national Budget. 3. The most radical but the most effective approach is giving the task of checking the precision and transparency of the budgetary process to some private institution. Apart from that, the national Budget has to be based on economic forecasts and projections of international organisations or private institutions in order to avoid strategic manipulations of the forecasts.

To boost fiscal transparency in the RC it is necessary to:

1. Ensure a functional classification of the extra-budgetary funds, including the privatisation fund.
2. Improve the statistics of local government, which should be gathered by the MF and not the Payment Clearing Institute (PCI). These statistics will have to include data about transfers and grants given by local government units to each other, consolidated with the budgets of all types of government.

3. Incorporate public enterprises, agencies and banks owned by the state (e.g., the CBRD) into the regular Budget. Lack of transparency of transactions among them creates great opportunities for various kinds of irregularity and waste.

4. Coordinate and unify the gathering of data about the preparation and execution of the Budget from various sources, like ministries, agencies, extra-budgetary funds, local government and the PCI. Even data inside the Finance Ministry are frequently insufficiently transparent.

5. Improve the statistics system, and in particularly computerisation, in the extra-budgetary funds so that the data might be obtained in time.

6. The Finance Ministry should publish more consistent and more de-aggregated data, with more analysis. In this case it might be possible to make a more detailed analysis of public expenditure.

For an evaluation of the real level of public investment in Croatia, the resources and transactions (to do with loans) of the CBRD have to be consolidated with the resources and transactions with the central government.

## PART THREE

### 3.1 About the public debt

#### *The concept of public debt*

Since it is exceptionally difficult to define unambiguously everything the public sector in the economy covers, it is clear that the definition of the indebtedness of the public sector is also not without its problems.<sup>1</sup> In all countries what certainly figures in the public debt is borrowings by central and lower governmental units. However, if the public debt is defined as the accumulated borrowings of the state, or the sum of all claims that its creditors have upon the state at a given moment, are then not the debts of the public corporations, the state agencies or the social security and other “national” funds also part of the public debt? According to the common conception of the public sector, the answer should be affirmative, but in the practice of quite a large number of countries this is not the case, and so in particular in the case of international comparisons it is necessary to take account of the problem of the varying scope of the concept of public debt.

<sup>1</sup> It is necessary to differentiate debt from deficit. Debt at a given moment of time comprises the sum of all the budgetary deficits made in the previous period. When one talks about the public debt, this is to do with cumulative budgetary deficits that the state has financed by borrowing. That is, debt is measured at some given point in time, while a deficit is a measured in some period of time.

Since the public sector has a different scope from country to country, the IMF has developed a statistical system for public finances (*GFS - Government Finance Statistics*) that relatively precisely and uniformly define the public sector.<sup>2</sup> Respecting GFS methodology and the definition of the “general government”, the public debt of the Republic of Croatia can be defined as the sum of the borrowings of the national Budget, the extra-budgetary funds and units of local government. Depending on whether the debt is owed to creditors at home or abroad, we distinguish between internal and external public debt.

In the sense of public debt, the term the *national debt* can often be encountered. However, the need to make certain distinctions does nevertheless exist. When it is a matter of the internal public debt or the indebtedness of the country, one can really say that these are synonymous. On the other hand, in connection with the foreign debts of a country, we can say that it is a wider concept, because it includes both the indebtedness of the public sector, i.e., the public debt, and also the foreign debt of the other economic sectors (banks, companies, households). Sometimes for public debt the term public credit or loan is used, but public credit (loan) is a narrower concept than the public debt and represents just one of the way of financing the public debt.

#### *Problems / situation*

#### Structural and conjunctural budgetary deficit

Apart from the state borrowing for structural reasons, for example, to finance certain infrastructure and other projects that are publicly useful, a public debt can also be an important instrument of macroeconomic policy. Used at the right moment, the public debt can contribute to the stimulation of economic growth and the improvement of the overall economic conditions, which as well as on the growth of budgetary revenue also has a positive effect on employment and incomes. Used in the right way, the public debt can give a positive impulse to a growth in domestic savings, the creation of an investment culture and contribute to the development of the capital market. For example, such a stimulus can be the refinancing of an old debt with new and marketable instruments, which opens the door for the central bank to use indirect market mechanisms to implement its monetary policy. The domestic market for the public debt will deepen, increased market liquidity leads to additional investor confidence and the future stable yield curve from the long-term public debt becomes the most reli-

able market signal about where (at home or abroad) it is most profitable to put the national economy in debt. If we look at the situation in this country in the light of these facts, we can conclude that the effects of structural borrowing and the macroeconomic aspects of the public debt at the level of decision makers in professional and political circles have not been debated. If there actually has been some debate, nevertheless, no tangible positive results have appeared.

#### Government borrowing and monetary policy

Since financing the deficit with direct or indirect (long-term) borrowing from the central bank is nothing but a straightforward increase in the money supply, most countries have a strictly legally regulated relationship between the central bank and the government. From this point of view the relation between the central bank and the state today is largely related to short-term bridging loans to tide the government over the gap between the inflow of revenue and the execution of budgetary expenditures. In our case, the national Budget can borrow from the CNB up to 5% of the amount of the Budget, short-term, while no ban on long-term borrowing at the CNB is expressly stated in Croatian legislation. What is more, the government can go in for long-term budgetary borrowing by the passing of a decree with the force of law, which was made possible by the passing of the “Law about the authority of the government of the Republic of Croatia” to determine some questions from the sphere of influence of the House of Representatives of the Parliament of the Republic of Croatia.

#### The political aspect of the public debt

Every responsible government has to pay attention to the impact of obligations arising from the public debt and repayments of it on future budgetary expenditure, because short-term thinking can considerably affect a qualitative narrowing of space for future decisions. Using the public debt deliberately to achieve momentary political effects and roll over the costs of them to the future has a negative effect on the maintenance of the flexibility of the national budget and mainly entails a reduction in prosperity for future generations. This means that the question of financing public expenditure by borrowing or taxation, has, apart from an economic, a political component as well, and that there has to be a clear legislative framework in order to control public sector borrowing. From this point of view, in the Republic of Croatia there has so far been no integrated law, (for instance, a public debt law), to regulate public sector borrowing. Instead, the problems of the borrowings of the Budget, the extra-budgetary funds, and local government, are regulated by different laws, including the Budget Execution Law, which is passed yearly.

<sup>2</sup> GFS are coordinated with the system of national accounts and other statistics (balance of payments, monetary statistics). With respect to the coverage of the public sector, not even the GFS methodology is perfect. The public sector in the gathering of statistical data is limited to the so-called “general government” and does not embrace, for instance, public corporations or monetary institutions. However, in countries in transition, the application of a unified definition and classification system represents an enormous gain in a clear and unified statistical coverage of the public sector. In the Republic of Croatia, statistical data in the public sector have been kept according to GFS since 1994.



## The problem of state guarantees

Although it is not a direct debt by the state, a state guarantee can become so at any moment and become a burden to the national budget and the taxpayer. The use of a state guarantee can be seen in the reduction of the cost of financing those figures in the economy that have the ability to pay back a debt. Those who do not have this ability either today or in the future are the main source of danger for the transformation of a guarantee into a public debt. The fact that the number of valid and activated guarantees is constantly growing focuses particular attention on the importance of a strictly regulated and transparent procedure for issuing guarantees and on the need for collaboration of all the institutions that have some authority in the matter. In line with this, state guarantees issued should be an integral part of the statistics of the public debt, which, separately from the real public debt, should contain a review of all current state guarantees, that is, of potential public debt. Thus, when it thinks of how the deficit will be financed and whether at home or abroad, a responsible government, apart from its "own" financial needs, has to bear in mind both the economic effects of borrowing at present, and the consequences of the repayment of the debt in the future. It also has to be aware that putting out a helping hand for those who cannot tread water in the market can pull even the best intentioned lifeguard to the bottom, especially if he overestimates his own capacities.

## The current state and structure of the Croatian public debt

The largest part of the Croatian public debt derives from the particular features of the former political and economic system, and collapse, of ex-Yugoslavia. This relates to both the internal and the external public debt. At the moment it is not possible to forecast the trends in the state and structure of the Croatian public debt and whether the burden will grow in time. It seems that the reason for this lies only to a small extent in the uncertainty and challenges that time brings, but mostly in the lack of respect for the elementary laws of economic theory and practice. From the point of view of the public debt, the application of IMF GFS standards should have made possible in the country a precise way of registering the state of both the domestic and the foreign public debt. However, there is a general impression that domestic public debt statistics lag considerably behind other public sector statistics. This can particularly be seen in the fact that the Finance Ministry of the RC has not even today published an overall review of the state and structure of the public debt, although Article 35 of the Budget Law obliges it to keep a schedule of the public debt. The inevitable conclusion is that: (a) since the passing of the Budget Law in 1994 no integrated and complete schedule of the public debt has actually been drawn up, or (b) the data are known, but are not being made available to the public.

## Incautiously = irresponsibly

In the light of the current economic situation and the savings and investment gap, one has to bear in mind the importance of a cautious and carefully thought out approach to public borrowing, particularly abroad, and an efficient use of borrowed funds. Foreign saving can easily become a double-edged sword, particularly if the funds borrowed are not used effectively. And it is a fact that particularly the "inherited" debt, which is a preponderant part of the total public debt abroad, was not effectively used, while "new" borrowings are also dubiously effective. The economic (lack of) independence of the country, particularly its role and position in international capital markets, also has a very important impact on public debt policy. Thus for a small country it is an imperative to fit the dynamics of borrowing to the situation in the international market.

Looked at from the level of the national economy, pulling out of the domestic market and turning to the foreign market hardly represents magnanimity on the part of a government that wishes to prevent private demand from being crowded out, rather it is a superficially rational decision to seek cheaper financing abroad. However, if it does not pay the state (which by definition always borrows at the most favourable conditions) to borrow even the smallest amount on the domestic market, how could it pay private enterprise? If we recall once more the view of most experts in the field that the state is a relatively inept entrepreneur and that according to the criterion of efficacy public investment cannot compare with private sector investment, it is clear why decision-makers have to be aware that the Croatian debt is not the same as the American public debt, which can be refinanced until the day of judgement and in essence never falls due, and that hiccups in the world capital market can have serious consequences, particularly for small and open economies.

## *Proposals and measures*

### The statistical coverage of the public debt

It is high time the Finance Ministry drew up and published an integrated schedule of the public debt. This should, apart from the government level, also include lower levels of government and the extra-budgetary funds. Apart from expanding the statistical framework, it is necessary to reinvestigate and adjust the already existing methodology of data gathering.<sup>3</sup> The state of the external debt is tracked by the CNB, as part of the entire foreign indebtedness. However,

<sup>3</sup> Even if we neglect the statistics of the Finance Ministry of RC not publishing (keeping up with?) the state of the debt of the extra-budgetary funds and local government, the requirement for the reinvestigation of the existing methodology derives from the fact that from the monthly data of the MF about the internal debt of the RC it is not possible to see the state of the debt at the CNB (see e.g. Table 12 from the monthly statistical review of the MF no. 49 and Table C1 from the Bulletin of the CNB no. 44). This very large-scale oversight alone gives grounds for an overhaul of the entire methodology of gathering data about the state and structure of the public debt in the Finance Ministry.

CNB statistics from this point of view depend on the very questionable alacrity of the MF in reporting borrowings made. For this reason the Finance Ministry should keep records about the state and structure of the foreign public debt (in terms of instruments, debtors and so on) that after coordination with the CNB should be made available to the public.

#### The sale of state assets and the public debt

Anticipated revenue from the privatisation of state owned corporations must not be the basis on which any kind of borrowing is made at home or abroad, as was the case, for instance, with Croatian Telecommunications. By its very nature, revenue from privatisation is one-off and ultimately depends on the market value of the assets being sold off. Market conditions and preferences change from day to day, and what was interesting to potential buyers yesterday will not necessarily be so tomorrow. The estimated value of all assets (particularly firms) is a relative affair, and therefore it is highly unreasonable to act on the principle of spending yesterday what we will get tomorrow. Tomorrow, for example, when they know that the vendor has got into debt on the basis of the assets being sold, potential purchasers are likely to offer less than would otherwise be the case.

When income from the sales of state assets is concerned, economic logic requires that in the state balance sheet that they should be cancelled, or placed in the items of the repayment of old debts or the purchase of other assets, and not in government consumption. If we restrict ourselves to revenue from state-owned firm privatisation there is no point in buying another company with funds derived from the sale of the first company. The only logical alternative is to buy up some of the public debt.

#### Public debt policy

An essential difference between private and public borrowing is that the benefits or damages that can arise from public sector borrowing will ultimately affect all the citizens of a country, without exception. In order to maximise the benefits, and reduce the possible damage to the lowest possible level, it is necessary to define a public debt policy. Just as good management represents the foundations of the business policy of a company, so the optimum policy with respect to the public debt has to start from management of the public debt. The legislative framework should provide a public debt law. This would, for example, in a single place, define the concept of the public debt; the conditions and manner of borrowing; authorities, responsibilities and competences; control mechanisms; effective and responsible management of the debt and of surpluses; risk protection and so on.

#### Issuing guarantees

The criteria that someone seeking a guarantee must satisfy have to be clear and accessible to the public, and the possibility of discretionary (political) decisions must be reduced to the absolute minimum. When the conditions are being determined, the credibility of the guarantee-seeker has to be in the first place, because no right-minded country allows state guarantees to be used to bail out troubled companies; instead, they are part of the policy of encouraging investment, exports and so on.

The state of affairs has to be urgently recorded, i.e., it is necessary to establish the amount of currently valid guarantees and/or activated guarantees (which have de facto become part of the public debt). This relates not only to the Finance Ministry, but also to potential guarantees from lower levels of government, and the issue of guarantees by authorised state agencies and establishments (the Croatian Guarantee Agency, the Croatian Bank for Reconstruction and Development). The list of guarantees has to be updated all the time and made publicly available, monthly, for example, or quarterly.

## PART FOUR

### **4.1. Review of the Croatian taxation system**

#### *The current situation of the tax system*

After independence, Croatia set about reforming the inherited taxation system. Reform started in 1994, when the Income Tax Law and the Profit Tax Law were passed, when excise taxes were introduced, and concluded in 1998 when the VAT Law, passed in 1995, started being implemented. The objective of tax reform was the creation of a modern market-oriented taxation system that was to as great an extent as possible founded on the following principles of taxation:

- neutrality in terms of economic decisions, i.e., taxes have no effect on relative prices and do not interfere with the allocative efficiency of the economy;
- a broad tax base, with as few exemptions as possible (a broader base permits the application of lower rates);
- the macroeconomic tax base should be consumption, so that savings and investment are to the greatest possible extent freed from taxes;
- taxes have to provide sufficient public revenue to allow the state not to have to borrow to cover reasonable levels of public expenditure;

- taxes have to be equitable, that is they have to be paid according to economic strength;
- the minimum family income should not be taxed; this introduced progressiveness into the system;
- welfare politics should not be managed by taxation policy measures; it is much more effective to carry out welfare policy by direct transfers from the Budget;
- taxes have to be as simple as possible to keep collection and compliance costs down,
- the taxation administration has to be efficient, quick, transparent and incorruptible, so as to reduce the size of the grey economy.

This kind of taxation system ensures an efficient allocation of resources (because it distorts relative prices to the smallest degree), improve supply of labour, encourages private investment, reduces the unofficial economy and finally ensures the basic economic aim, and that is economic growth. At the same time it ensures that the tax burden of those sections of the population most at risk is lightened.

### Proposals for change in the taxation system

The application of these principles is largely respected in the Croatian taxation system, and it should not in the future be very greatly changed. However certain specific adjustments that will not upset the consistency of the existing tax system but improve its action and correct negative effects are desirable. One should stress that all changes in the tax system should be borne out by professional research to consider all the positive and negative consequences of a given measure, and link changes in taxation with changes in other fiscal variables.

## 1. Reduce the total tax burden

The total tax burden has to be reduced. A high tax burden brings high tax distortions, i.e., loss of allocative efficiency and stagnant growth. As shown in Table 1, the total tax burden in Croatia is high, and has been rising in recent times. The total burden with taxes and contributions at the level of consolidated general government rose from 44.40% of GDP in 1995 to 46.61% of GDP in 1998. It is necessary to set about reducing it, but not so that the need to finance the government by borrowing occurs. So it is necessary to reduce public expenditure, which is difficult to do in the short run and unsystematically, especially if one bears in mind the traditional downward inelasticity of public expenditure.

## 2. Lower the standard rate of VAT and the contributions rate

It is possible to lower the total tax burden by reducing the VAT rate and cutting contributions. In

comparison with other countries, the level of total tax burden in Croatia is high (see Table 2). It comes to 46% of GDP in Croatia, in EU countries to 42%, and to 41% in countries in transition. Thus it is necessary to cut tax rates, which refers particularly to cutting the standard rate of VAT and contributions.

Table 1 TAXATION REVENUE OF CONSOLIDATED GENERAL GOVERNMENT

<i>In million kuna</i>	1995	1996	1997	1998
Total taxation revenue	43,677	47,962	53,282	64,506
Income tax	5,732	6,916	6,714	8,051
Corporation tax	1,401	1,772	2,504	3,477
Social security contributions	13,920	15,534	17,725	19,215
Assets tax	476	551	748	810
Sales tax	17,877	19,011	20,648	28,114
International trade tax	3,922	3,942	4,675	4,256
Other taxes	350	236	267	582
<i>Percentage of a given tax in total tax revenue</i>				
Income tax	13.12	14.42	12.60	12.48
Corporation tax	3.21	3.69	4.70	5.39
Contributions	31.87	32.39	33.27	29.79
Assets tax	1.09	1.15	1.40	1.26
Sales tax	40.93	39.64	38.75	43.58
International trade tax	8.98	8.22	8.77	6.60
Other taxes	0.80	0.49	0.50	0.90
<i>As a share of GDP</i>				
Total tax revenue	44.40	44.42	42.67	46.61
Income tax	5.83	6.40	5.38	5.82
Corporation tax	1.42	1.64	2.01	2.51
Social security contributions	14.15	14.39	14.19	13.88
Assets tax	0.48	0.51	0.60	0.59
Sales tax	18.17	17.61	16.53	20.31
International trade tax	3.99	3.65	3.74	3.08
Other taxes	0.36	0.22	0.21	0.42
<i>GDP (according to NSO)</i>	<i>98.382</i>	<i>107.980</i>	<i>124.881</i>	<i>138.392</i>

Source: Monthly Statistical Review of the MF, no. 49

Table 2 TAXES AND CONTRIBUTIONS AS PERCENTAGES OF GDP  
IN CERTAIN COUNTRIES IN 1966

	Taxes and contributions	% of GDP	
		Taxes	Contributions
<b>EU countries</b>			
Denmark	52.2	50.6	1.6
Sweden	52.0	36.5	15.5
Finland	48.2	35.8	12.4
Belgium	46.0	31.1	14.9
France	45.7	26.0	19.7
Luxembourg	44.7	32.8	11.9
Holland	43.3	26.1	17.1
Austria	44.0	28.7	15.3
Greece	40.6	28.1	12.4
Italy	43.2	28.5	14.8
Germany	38.1	22.6	15.5
United Kingdom	36.0	29.8	6.2
Spain	33.7	21.6	12.1
Portugal	34.9	25.9	9.0
Ireland	33.7	29.1	4.5
<b>Mean</b>	<b>42.4</b>	<b>30.2</b>	<b>12.2</b>
<b>Countries in transition</b>			
Czech R	40.5	23.5	17.0
Hungary	40.3	26.8	13.5
Poland	42.1	28.9	13.1
<b>Mean</b>	<b>41.0</b>	<b>26.4</b>	<b>14.5</b>
<b>Croatia (1995)</b>	<b>44.4</b>	<b>30.2</b>	<b>14.1</b>
<b>Croatia (1998)</b>	<b>46.6</b>	<b>32.7</b>	<b>13.9</b>

Sources: Revenue Statistics 1965-1997. OECD. 1998  
Monthly statistical review of the Ministry of Finance, no. 49.

### 3. Reducing the rate of contributions

It is necessary to lower contributions as soon as possible and bring them closer to the level in other countries. In Croatia the total rate of contributions from and on salaries comes to 41.2%, while in OECD countries they are paid at an average rate of 30.2%, of gross earnings. This directly threatens the competitiveness of Croatian exports, because the product exported is burdened with the high costs of domestic labour. This is not the case with VAT, because exports are zero rated, and so goods go off abroad entirely exempt from VAT. But particular mention should be made of the fact that lowering contributions can be done only if the process is linked with a comprehensive and thoroughgoing reform of the pensions and healthcare system.

### 4. Lower the standard VAT rate without introducing any new rates

VAT is most efficient if it is applied to the broadest possible base, with the application of a single rate for all products and services (being zero rated only for exports), and with as few exemptions as possible. The single rate should be gradually reduced to the level of 18-20%, without any new rates being introduced or the zero rate being extended. But this is directly related to the speed at which public expenditure can be

reduced. VAT, that is, is the most productive Croatian tax, and brings about 20 billion kuna in revenue annually, constituting over 50% of total tax revenue. Every change in the rate thus has a great impact on changes in the amount of tax collected. No more rates should be introduced, neither should the scope of the zero rate be expanded. Enough damage was done at the end of 1999, when the zero rate was introduced for milk, bread, drugs and books (see more in the section dealing with why the rate of VAT should not be changed). That is why, depending on the success achieved in altering the expenditure side of the Budget, only reductions to the single rate of VAT should be considered.

### 5. Keep to the principle of taxing consumption, not saving or investment

One of the main problems in the Croatian economy is the low level of private investment. However, the reason for this state of affairs lies more in general economic and political conditions than in the taxation system. The Croatian taxation system, that is, is based on the taxation of consumption, not of investment and saving. The income and corporation tax system is built upon this principle. Thus interest, dividends and capital gains are not taxed, the institute of protective interest is applied, which means that a company's own equity is not taxed, and depreciation is accelerated. Taxation of consumption was complemented by the introduction of VAT in its consumption form. When the consumption principle was introduced into the taxation system, it was because there was a wish to achieve tax neutrality in the making of economic decisions and avoid double taxation of income. Accordingly, in this part there is no need to change income and corporation tax.

### 6. The corporation tax rate should not be reduced

It is not necessary to reduce the corporation tax rate, because a large amount of relief is inherent in the corporation tax system as it is. It is already at the level of the rate applied in a great number of countries. Apart from that, a lot of research has shown that private investment is to a great extent more sensitive to changes in the general political and economic environment than to changes in tax policy. Therefore it is more important to maintain the stability, neutrality, simplicity and transparency of the taxation system, to contain tax evasion, than to reduce the rate at which profits are taxed. A stable tax policy should be just a part of total economic and political stability. This will lead to both foreign and domestic investment taking off.

### 7. No new tax exemptions to be introduced, existing ones to be abolished

It is certainly necessary to resist pressures to introduce additional tax exemptions and reliefs with respect to income and corporation tax for certain industries, regions or population categories. Taxation neutrality means that tax conditions have to be the same for all

players in the economy. Economic growth has to be directed by other measures (see the section The role of the state in the Croatian economy), not by instruments of taxation. The exemptions that during the last few years were indirectly introduced into the taxation system should be abolished (for war veterans, artists, sports people, areas of special state concern and so on), having upset the consistence and neutrality of the system.

## 8. Re-examine the amount of personal allowances in income tax

Since as well as the personal allowances there are related allowances for dependents, an increase in them will ensure a better welfare position for the households the most at risk. At the same time, an additional progressivity is thus introduced into the system, neutralising the possible regressive effects of VAT, i.e., its characteristic of burdening the income of the poor to a greater extent. The World Bank recommendation is that the annual level of personal allowance be set at the amount of one per capita GDP. But this amount in our conditions depends on the extent to which VAT is regressive. Since there are no reliable figures for this, it is necessary to stimulate research so that the dimensions of the regressivity of VAT be explored, as well as of the whole of the taxation system, and contribute to the growth of tax evasion.

## 9. Not introduce any more rates for income tax

If at all possible, the temptation to introduce a medium rate for income tax should be resisted. Most countries aim at reducing the number of rates, which makes the system simpler and cheaper. Welfare policy can be run much more efficiently by welfare transfers, because they can be targeted more accurately to those who really need help than with tax instruments.

## 10. Excise tax changes

So that the rich should pay more tax, it is not necessary to reduce the number of luxury products that are subject to excise taxation (although this measure too can have dubious results). One should not change the taxes imposed on products such as petroleum derivatives, tobacco and alcohol, because taxation reduces the consumption of such demerit goods. But it is worth re-examining the justification of excise on non-alcoholic beverages and lower capacity cars, which has a direct effect on the standard of living of the population.

## 11. Reduce tax evasion

The most recent research done in the Institute for Public Finance shows that in 1996 tax evasion in Croatia came to some 9-15% of estimated GDP, while the share of the unofficial economy came to about 25%. Since according to some criteria an unofficial economy of less than 10% of GDP can be considered small and of above 30% large, Croatia, with 25%, is certainly among the group of countries with a large

unofficial economy. In order to eliminate this phenomenon, apart from reducing the tax burden (particularly the reduction of the burden of contributions) it is necessary to go on with measures that contribute to increasing the efficiency, credibility and incorruptibility of the tax administration.

## 4.2. Why a single rate VAT is best?

Almost two years have passed since the initial implementation of VAT (or PDV in Croatian). But not even after this amount of time have the polemics about this new form of taxation ceased; on the contrary, in recent times they have actually been stepped up. There have been many criticisms of the new tax; however, an analysis of them would tend to show that most of the complaints have referred to the implementation of a uniform rate of taxation. Some taxation experts, politicians, the media and the citizenry hold that the system of VAT with a single rate is regressive, i.e. it tends to hit the poor relatively hard, since they spend more of their income and save less. In order to palliate the regressive effect of VAT, what is almost always recommended is the introduction of a large number of rates (at least two), even the introduction of a zero rating for basic necessities. In addition, representatives of some branches of the economy (the tourist industry in particular) have been making themselves heard, claiming that their survival is threatened by the implementation of a single high rate of VAT, and seeking the introduction of a lower rate.

Behind these criticisms there are a number of key questions. Is a single rate VAT regressive? Should its regressive effect be corrected by the introduction of several rates? Does VAT really put the growth of certain branches of the economy at risk? We shall attempt to give an answer to these questions in ten theses.

**1. The question of regressiveness is hard to define unambiguously.** It is questionable because it is not a matter of indifference as to which base one looks at – income or consumption, or to what period the observation relates. VAT covering most products and services, levied at a single rate, has by definition a proportional effect when it is measured according to consumption and a regressive effect when it is measured according to income. The reason for this is that savings as a part of income increase when income rises. Accordingly, when progressiveness is discussed, there should be some mention of what base it is observed in connection with, consumption or income.

The conception of regressiveness also changes when it is looked at over the long period. Then the burdening of income by VAT may become proportional. Consumption taxes (which include VAT), as their very name implies, put a burden on consumption and not savings. Since savings are deferred consumption, they are, when converted into consumption, subject to

VAT. Thus the rich, though they save more, are in the end not exempt from VAT. They do pay it at the moment when they turn their savings into consumption. Thus, looking at it dynamically, not statically as when just the household budgets of the well-to-do and the poor are observed over the period of a single year, the concept of regressiveness changes essentially. When income is observed as lifetime income, then, assuming that the whole of the income is spent by the end of a lifetime, and that savings are not transferred to heirs, it is equivalent to consumption. And the proportion of VAT in income is proportional, because VAT burdens all expenses on consumption equally. Rich man and poor man are now equally burdened by VAT. If income is observed over the whole of a lifetime, then, and not just as annual income, the concept of regressiveness is questionable. In such conditions, VAT is a proportional burden on the income that an individual can earn over the whole of his life.

Irrespective of this relativisation of the concept of regressiveness, it nevertheless has to be admitted that the concept of the regressiveness is habitually linked with annual income, and it is then accurate to say that a single rate of VAT burdens the poor more. In their income, consumption forms a far greater part than it does in the income of the wealthy. As against this, in poorer members of the society, savings are regularly much smaller. However, proposals that this regressiveness be palliated by the introduction of a multi-rate VAT should be resisted. For a VAT system with several rates has a large number of drawbacks.

**2. In Croatia, it is impossible precisely to define the extent of the regressiveness.** When VAT with a single rate of 22% was introduced to replace turnover tax with five rates in which the standard rate came to 26.5% (15% plus 10% retail sales service tax) there was certainly a shift in relative prices. What the final effect of such changes in relative prices on various categories of the population was is quite difficult to determine unambiguously. There is as yet no research of the distribution of income and of the tax burden in Croatia, and it is impossible to comprehend the regressive effects of VAT. Lack of information about the real size of VAT regressiveness makes it more difficult to make conclusions, and creates a fertile ground for the work of demagogues.

Apart from this, when there is discussion of the regressive effects of VAT, one should not forget that there are other forms of tax that also apply differently to the incomes of individuals. Unlike VAT, some of these forms of tax, for example income tax or excise taxes, have progressive features, and they have to be taken into consideration when the effects of taxation on individual income groups of the population are considered. Also to be considered is the effect of "negative taxes", i.e., subsidies (various forms of welfare) that are received by the poorest members of the population. Thus VAT should not be considered in isolation when discussing the impact of taxation on the population; rather, one should take into considera-

tion all forms of taxation, including their negative components, i.e., all forms of welfare.

**3. Empirical research about the regressiveness of VAT largely bears out the thesis that it cannot be used to reduce differences.** In Ireland, for example, it has been ascertained that in absolute terms the rich spend twice as much on food as the poor, although the poor spend relatively more of their income than the rich on food. Accordingly, the zero rating of food in Ireland provides twice as much a tax break for the rich as it does for the poor. A Swedish study showed that the abolition of the zero rating for food would mostly benefit single people in the high income groups, because they usually buy more expensive food. In addition, the demand for books, newspapers and magazines is very income elastic. In other words, the rich buy more books and other forms of printed matter, and a cut in the rate for publications would make VAT still more regressive.

**4. The introduction of several rates requires a detailed definition of taxable products.** If vegetables are taxed at a reduced rate, does this mean that fresh, canned and frozen vegetables are taxed at a single rate or different rates? Should there be a same rate of VAT for lettuce and for artichokes? Nor are all kinds of lettuce the same, and it is then necessary to define whether there is a need to embark on a further distinction of products. The process of defining the products for different rates gets very complex and gives rise to further discussion, most often about borderline products that in their nature can be taxable in terms of two different rates. The definition of products requires a professional and intelligent tax administration capable of giving clear, convincing and well-supported explanations of its decisions in public discussions about rates that tend to become very heated. Thus the introduction of several rates complicates a tax administration and makes it more expensive than a system with a single rate.

**5. Unclear definition of products opens up the door to tax evasion.** This relates to all products that are not unequivocally defined. Taxpayers will attempt to put them in lower rate categories. The use of several rates will open the door to corruption and lobbying, for many will wish to persuade the state to put their product in the lower rate category. Thus powerful lobbies will get into the VAT system.

**6. Increasing the number of rates will lead to an increase in the administrative costs of collecting the tax.** A state that uses several rates of VAT will have to have more civil servants for the processing of complex tax returns than a state with a single rate VAT. In addition, the costs of calculating and paying VAT in the companies will also rise. The well known taxation expert and long-term director of the Fiscal Department of the IMF, Vito Tanzi, said in 1993 that with a transition from one to two rates, the costs of VAT administration went up five times, and

with a change to three rates, ten times. The increased costs of the tax administration and of the compliance costs of the corporate sector in the collection of VAT with multiple rates should certainly not be neglected in discussion of introducing a lower rate of VAT.

**7. Lower VAT rates are no guarantee of lower prices.** Lower rates of VAT in tourism, for drugs and food do not automatically mean a lowering of prices for these products. In a free market, prices are formed according to supply and demand. Traders set their prices according to the elasticity of demand, that is, according to what the market will bear, irrespective of the rate of taxation. Accordingly, a lower rate of VAT is no guarantee that the poor will pay lower prices, nor is a lower VAT in tourism a panacea for all the problems in this branch of the economy. It would be very nice indeed if all the problems in the Croatian tourist industry could be solved through the introduction of a lower rate of VAT.

**8. Various rates of VAT distort consumer preferences.** It is usually said that lower rates for food should be introduced because the poor spend more on food in their household budgets than the rich. But the rich spend also on milk, meat and oil. Why should such products be taxed at a lower rate, the rich thus being helped just like the poor? The introduction of lower taxes for food will indirectly subsidise the rich.

As against this, taxing luxury products at higher rates will discourage the poor from occasionally upgrading their consumption with the more expensive product. Do the poor have no right to buy luxury products? Is the purchase of luxury products considered the exclusive right of the rich, with enough money to pay high taxes on such products as well? Why introduce such discrimination into consumption? The poor can be helped much more effectively with the aid of direct transfers from the budget or by a progressive income tax. Total income formed in this way (earned income plus welfare payments) will help the poor, in a single rate VAT system, to adjust their consumption to their own preferences, and not to the rates of taxation.

**9. Lower rates of VAT mean less revenue to the national budget.** In such a situation, the state would very likely be forced to increase the standard rate of VAT in order to obtain revenue adequate for its own inelastic expenses. An increase in the standard rate would lead to a still greater wave of discontent, for it would be applied to the greatest number of products and services.

Apart from this, today about 50% of budgetary revenue is derived from VAT (Table 1), and a small shift in the rates would bring about great changes in the level of tax revenues. For this reason the Croatian Ministry of Finance has to be extremely cautious when making any decision about the number and the amount of rates. Reducing the rates for some products would mean a reduction of taxation revenue or would lead to the standard rate being put up from 22%

to some higher level, or would lead to an increase in other types of taxes, or would result in a serious reduction in budgetary expenditures.

**10. The EU is tending towards a smaller number of rates of VAT.** Many say that in the area surrounding the Croatian economy, mainly implying the EU, a system of VAT with several rates is employed. This is indeed true. Of the EU countries, only Denmark has a single rate system, and of OECD countries, only Japan and New Zealand have a single rate system (Table 2). But the EU is a community of fifteen states with different tax systems. Coordination of their tax systems is underway, and comprises a painful and long-term process in which each country feels that interference with its taxation system is an attack on its sovereignty. However, the EU recommends its members the reduction of numbers of rates of VAT so that there are only two: a standard one of 15% and a reduced one, of not lower than 5%. The EU too, then, is tending towards a single rate, and the end result of this long lasting process is certain to be a single rate. This is possible to state with a great amount of certainty because contemporary taxation theory has on the whole unambiguously and unanimously opted for the adoption of single-rate VAT with a small number of exemptions and zero ratings and a broad tax base. EU countries introduced VAT in the sixties and seventies, when the attitude towards a single rate was not so explicit. Their aim was that the tax burden should be as similar as possible to that with the sales tax in order to facilitate acceptance of a completely new form of taxation of consumption, a form that until then had never been implemented. In Croatia a taxation system founded on the experience of EU countries should be retained, and VAT in its best form be continued, which certainly means a system with a single rate.

Convinced that the regressiveness of VAT can be palliated with the application of a number of rates, the transition countries, guided primarily by political motives, have largely introduced multi-rate VAT systems (Table 3). Unfortunately, they have not paid attention to foreign experience about the drawbacks of multi-rate systems, and they are now burdened with a number of problems, of the kind entailed by such systems on the countries that were the first to introduce VAT.

Finally, it should be said that the comparison of a tax in several different countries does not have a great deal of point. A correct approach would involve a comparison of the entire taxation system, and also of the welfare system.

## Conclusion

Although we are aware of the regressive effect of a single-rate VAT, at the same time we are convinced that VAT should not be used to attain objectives that it cannot address in the most satisfactory manner. The aim of the tax is to gather revenue by taxing consumption, not to carry out measures of welfare or industrial policy. Its regressive effects must be corrected

by other instruments of the fiscal system, such as aid to the poor, and progressive income tax and other forms of taxation. Economic theory and practice show that the application of target measures that are aimed at a clearly selected group of citizens is much more effective and cheaper for the budget than general, unselective measures that, intended to help just some, also assist those who do not need help. The introduction of several rates of VAT will not do away with its regressive effect, but will also obliquely subsidise the rich. A several-rate system is a clumsy way of palliating the regressive effects of a single-rate VAT system. The good features of a single-rate VAT, such as neutrality and collection efficiency should not be sacrificed to introduce a much more complicated form with several rates that will introduce new distortions in to the market and addition-

rect transfers from the budget in the form of welfare will exacerbate the problem of the optimal allocation of resources. The aim of reducing the overall tax burden, which came in 1997 to as high as 50% of GDP (expenditures of general government as a percentage of GDP) and which is still rising can be achieved by other changes: reduction of the standard rate of VAT from 22% to a lower rate or by reducing the contributions rate, which greatly increases the costs of labour. But a precondition for a permanent reduction in taxation pressure is a reduction in budgetary expenditure. This relates in particularly to the great, accumulated problems in the pension and health-care insurance funds. Beginning to make reforms in these areas will have a crucial importance for a reduction in national expenditure, which will in turn allow a reduction in the tax burden.

**Table 1. BUDGETARY CENTRAL GOVERNMENT TAX REVENUE**

Current prices, 000 000 kuna

	1994	1995	1996	1997	1998
<b>Tax revenue</b>	22.377,48	26.505,35	28.530,43	31.338,17	40.327,49
Income tax	3.211,61	3.497,59	4.216,93	4.102,23	4.915,10
Profits tax	591,59	1.009,07	1.271,18	1.785,26	2.461,15
Real estate sales tax	117,67	141,76	171,78	242,70	270,92
Tax on sales of goods and services	14.920,74	17.762,70	18.895,16	20.538,00	27.968,26
VAT	0,00	0,00	0,00	0,00	20.228,23
Turnover tax	13.107,16	12.802,26	13.504,37	15.133,17	1.972,05
Excise	1.813,58	4.960,44	5.390,79	5.404,83	5.767,98
International trade tax	3.486,77	3.922,48	3.942,44	4.639,99	4.256,33
Other taxes	49,11	171,76	32,94	29,99	455,74
<b>Structure of tax revenue</b>	1994	1995	1996	1997	1998
Tax revenue	100,0	100,0	100,0	100,00	100,00
Income tax	14,4	13,2	14,8	13,09	12,19
Profits tax	2,6	3,8	4,5	5,70	6,10
Real estate sales tax	0,5	0,5	0,6	0,77	0,67
Tax on sales of goods and services	66,7	67,0	66,2	65,54	69,35
VAT	0,0	0,0	0,0	0,0	50,16
Turnover tax	58,6	48,3	47,3	48,29	4,89
Excise	8,1	18,7	18,9	17,25	14,30
International trade tax	15,6	14,8	13,8	14,81	10,55
Other taxes	0,2	0,6	0,1	0,10	1,13
<b>As percentage of GDP</b>	1994	1995	1996	1997	1998
Tax revenue	25,6	26,9	26,4	25,5	29,7
Income tax	3,7	3,6	3,9	3,3	3,6
Profits tax	0,7	1,0	1,2	1,5	1,8
Real estate sales tax	0,1	0,1	0,2	0,2	0,2
Tax on sales of goods and services	17,1	18,1	17,5	16,7	20,6
VAT	0,0	0,0	0,0	0,0	14,9
Turnover tax	15,0	13,0	12,5	12,3	1,5
Excise	2,1	5,0	5,0	4,4	4,3
International trade tax	4,0	4,0	3,7	3,8	3,1
Other taxes	0,1	0,2	0,0	0,0	0,3
<b>GDP</b>	87.441,20	98.382,00	107.980,60	122.904,50	135.645,20

Source: Ministry of Finance, Republic of Croatia



Table 2. Current VAT rates in OECD countries

Country	Reduced rate	Standard rate	Higher rate
Austria <sup>1</sup>	10;12	20	
Belgium	0;1;6;12	21	
Canada	0	7	
Denmark	-	25	
Finland	0;6;12;17	22	
France	2,1;5,5	20,6	
Germany	7	15	
Greece <sup>2</sup>	4;8	18	
Iceland	14	24,5	
Ireland	0;2,5;10;12,5	21	
Italy	4;10;16	19	
Japan <sup>3</sup>	-	3	
Luxembourg	3;6;12	15	
Mexico	0;10	15	
Holland	6	17,5	
New Zealand <sup>4</sup>	-	12,5	
Norway	0	23	
Portugal <sup>5</sup>	5;12	17	
Spain	4;7	16	
Sweden	6;12	25	
Switzerland	2	6,5	
Turkey	1;8	15	23;40
United Kingdom <sup>6</sup>	0;2,5;8	17,5	

1) A rate of 16% is applied in the Austrian tax enclaves Mittelberg and Junghollen

2) In some outlying parts of the country the taxation rate is reduced by 30%.

3) 3% up to March 1997; 5% from April 1, 1997

4) For long-term lease of commercial property, standard rate VAT is collected on 60% of the value of the property.

5) From July 1996 the reduced rate of 12% has been applied to restaurant services and for some food products (and from October 1 expanded to cover other food products).

6) Standard rate applied at a reduced value of some artworks, ancient and collectors' objects, which makes the effective rate 2.5%.

Source: "Consumption Tax Trends", OECD, Paris, 1997.

Table 3. VAT rates in Central and Eastern Europe

Country	Reduced rate	Standard
Bulgaria	-	22
Czech R.	5	22
Estonia	0	18
Hungary	0;12	25
Latvia	-	18
Lithuania	-	18
Poland	0;7;17	22
Romania	0;9	18
Slovakia	6	23
Slovenia	8	19

Source: Cnosen, Sijbren (1999) in Rose, Manfred "Tax Reform for Countries in Transition to Market Economies", Lucius & Lucius, Stuttgart, 1999.

For Slovenia: "Denar", vol. IX, 15. June 1999.

## 4.3 The Tax Administration

### Basics

The efficacy of a tax system depends not only on appropriate tax laws, but also on the efficiency and degree of integration of the tax administration. A low level of budgetary resources collected can be ascribed either to the incompetence of the tax administration to carry out its task or to its greater or lesser degree of corruption. However carefully the tax laws might be framed, they cannot lessen the gap between the tax administration and the taxpayer, a tax administration made up of professional, responsible people thus being the most important condition in realising the tax potential of a country. Tax laws or a tax policy are good to the extent that the tax administration is up to its task. A tax system cannot be better than its administration, but even the best tax administration will be unsuccessful in turning a bad into an effective taxation system. Many ambitious tax reforms have fallen down because of the inefficiency of their taxation administrations. Without constant reorganisation of the tax administration, without day-to-day improvements in the methods of its administration, it is almost impossible to expect tax reforms to be effective and feasible.

### The situation

Although it can be said that from the points of view of organisation, personnel and fulfilment of its tasks the Croatian tax administration and in particular the control service in no way lags behind similar services in the world, it will nevertheless be necessary to work upon stepping up its efficiency and on updating it. This is the more important that in Croatia, as in most other countries in transition, the share of taxation that is gained from large, mainly state companies is reducing, and it has to be made up with taxes gathered from private, mainly smaller firms, and individuals. With a relatively low level of taxation morality and the unaccustomedness of taxpayers to paying taxes, the tax administration and the inspection service do not have very easy tasks. Equally important is the question of the further professional training of those employed in the revenue service.

### Reasons

In order to manage the changeover to the market economy, apart from privatisation, price liberalisation, limitation of the influence of the state on economic flows and other necessary activities, it is important to develop a contemporary tax system, which is to a great extent reflected in changes in the work and organisation of the taxation administration. It is held that the building of an efficient and comprehensive taxation system, in which the tax administration has a very important place, is one of the most complex and most serious of the macroeconomic difficulties to be met with by countries in transition. In all

countries in transition a great fall in GDP has been recorded, which, when combined with insufficient efficiency on the part of the tax administration, tends to result in alarming budgetary shortfalls. This results in pressure to increase the rate of existing taxes, and the introduction of new, frequently off-the-cuff, taxes. This motley situation, known as tax system patches, is largely the result of the incompetence of the tax administration in these countries to gather taxes that do exist, which leads to the incessant need to prescribe new taxes and carry out changes in the tax system, and to an almost permanent state of tax reform.

In Croatia, as in almost all countries in transition, there is a large tax disproportion brought about by a number of factors. First, the basic tax rates are relatively high. A large number of newly founded firms are headed in the direction of tax evasion, inveterate as it is, and working in the unofficial economy, by high tax rates. Secondly, contributions on wages are used for the financing of welfare benefits. Since these contributions are a burden on the employer, and tend to discourage his entrepreneurial energies, they make employment in the official economy more difficult and encourage work in the unofficial economy. Thirdly, tax exemptions, tax relief, various kinds of tax rates make the work of the tax administration more difficult and distort the allocation of sources of income. A key precondition for an efficient taxation administration is a tax structure in which there will be a very strict limitation on exemptions and in which there will not be any differences in the tax approach to individual branches of industry, regions, individuals. Stepping up tax efficiency and reducing evasion will almost certainly result in the feedback of being able to reduce the rates of taxation.

Not less important is the question of an efficient taxation administration. In a market economy it is based on the principle of the voluntary compliance of a large number of taxpayers. The tax administration should be organised around individual actions (such as the work of assessing and monitoring taxes, keeping records or reviewing), rather than being linked to a particular tax or group of taxpayers. In general, it is necessary to make tax assessment, collection and documentation more efficient. A tax administration must be up to the large number of taxpayers, many of which, especially private firms in production or services, are apt to find all kinds of ways of avoiding paying taxes. A better coverage can start with special attention to the large taxpayers whose taxes make up most of the tax revenues. This does not mean, of course, that the results of successful monitoring of large taxpayers can excuse neglecting medium sized and smaller taxpayers, because then one might find a reduction in their tax compliance, which would result in a reduction of the funds gathered as a whole. The next step should be stepping up inspection and activities directed to those who do not make tax returns or do not pay tax.

In Croatia, within the framework of reform of the entire fiscal system, reform has been carried out of the bodies charged with the assessment, collection and

the control of the collection of tax revenue, that is, a single Tax Administration has been founded, with local offices and branches throughout the country. Since the founding of the Tax Administration and the Financial Police, problems have shown up in organisational and functional points of view, limiting the work of the tax administration and increasing its costs. Shortcomings with respect to the independence of the Tax Administration have been seen, the number of local offices and the overlapping of competences with the Financial Police in carrying out inspection and control duties. Particular attention has to be devoted to the inspection of the large taxpayers. Changes require employees with appropriate qualifications and incentives on the basis of a better system of rewards for work. Remedying these irregularities and shortcomings, and undertaking measures to raise the efficiency of the tax administration will help the Tax Administration to become a smoother working whole in a quantitative and a qualitative sense, and will reduce its costs.

### *Recommendations*

The most important question to do with reducing the costs and increasing the efficiency of the work of the taxation administration is how to make new forms of organisation and new procedures acceptable in conditions of the existence of a certain tradition and of practices that are reinforced on a daily basis. Reform of the organisational structure of the tax department can be of crucial importance for the strengthening of the tax administration. A well thought-out organisational structure can lay the foundations for an efficient tax administration that will reduce the opportunities for tax evasion to the smallest possible extent, and encourage voluntary shouldering of the tax burden. To encourage efficiency, the organisational structure has to be linked with the objectives of the tax department. These targets of contemporary tax departments today include reduction of the costs of compliance, and ordinary activities such as collecting appropriate revenue in line with the law. In the last few years there has been a rise in interest in the reorganisation of the structure of the tax departments, which has partially been prompted by the growing concern for the protection of the rights of the taxpayer.

## **PART FIVE**

### **5.1 The unofficial economy**

#### *Basics*

The unofficial economy (UE) includes all kinds of activities, from almost legal transactions to totally criminal actions, while it usually implies actions that for various reasons take place outside the framework of the official economy. Other terminology is also used: the informal economy, the parallel economy, the black economy and so on. It includes tax evasion,

avoidance, side-stepping, abusing or degrading regulations, and the ancillary efforts needed to hide these unlawful activities from the authorities. In the event of failure to respect the fiscal regulations, tax evasion and fraud, this concerns *the unreported economy*; when the income made is not covered by the national accounts it is *the unregistered economy*; abuses of public position to obtain some profit make up the corrupt economy; and activities in which the regulations relating to the ban on extortion, financial fraud, smuggling, organised crime and theft of state property are broken are examples of the *illegal economy*. The size of and changes in the unofficial economy are important because they can be a source of independent economic changes, and affect the direction taken by and the strength of economic policy.

### The situation

According to the project *The Unofficial Economy in the RC* carried out by the Institute for Public Finance Zagreb (Financial Practice, 20:1-2, 1997) the share of the UE in Croatian GDP in 1995 amounted to at least 25%. Data defined according to sector are in line with this share and in 1994 ranged from 8 per cent in industry to 64 per cent in commerce. In the period from 1990 to 1996, two sub-periods can be clearly distinguished. During the first, which lasted until the end of 1993, according to all available data, the share of the UE in GDP increased. It is not possible to make a final decision about the second, which started in 1994, because although some indicators suggest there was a fall, other important indicators show a rise in the share of the UE. The actually calculated share of the UE is certainly large, and is also perhaps underrated; because of methodological problems, some occupations in which the UE tends to figure very strongly were not covered (personal services, construction). This large share will in all likelihood continue in the foreseeable future, because the inherited tradition, a transition process that has gone on with intensive sector and institutional restructuring, the great impact of the state in the economy (particularly in the privatisation process), tax pressure and the growth of new enterprise all tend to support the UE.

### Reasons

- The growth of the UE in the economy as a whole (measured by the national accounting system) up to 1993 might have been prompted by the fall in real incomes, high inflation, the existence of parallel means of payment in domestic transactions, a high tax burden and the war, while the fall in the UE after 1993 might have been brought about by the lightening of the tax burden on consumption, income and profits.
- As for growth of the UE in industry, agriculture and trade up to 1993, it is assumed that it was affected by the lack of financial control (war, the establishment of a new state with only nascent institutions), fall in production and real incomes (with people turning to the informal commercial

sector), the transition (reduction in employment in the formal sector going hand in hand with privatisation and restructuring), and the search for alternative and cheaper supplies. The fall of the UE since 1994 might be accounted for by the growth in financial control, the reduction of the tax rates, the restructuring of the big retail chains, real rise in incomes and so on. The renewed, unexpected, growth of UE in 1995, in spite of stepped-up checks by the Financial Police and the growth in real incomes in the population at large, could be explained by a high rate of growth of personal expenditure, a fall in the prices of imported as compared with home-produced goods, structural changes in consumption and increased demand for durables.

- The existence of the UE in international trade could be explained by things that occur in other transitional countries (slow economic growth, high unemployment, a high marginal rate of taxation, and a high level of public spending). In Croatia, however, the following factors were particularly prominent: inefficiency in the privatisation process, problems related to the achievement of the economy of scale, shortcomings in the legal system (adjustment of the legal system to the market economy has not yet come to a close) and weak penal measures for the suppression of illegal activities.
- The causes of the UE in privatisation might be a) the concept of privatisation chosen, which because of privileged sales had unfavourable consequences (the centralisation of all decisions about the transformation and privatisation at the level of the national administration; the nationalisation of a large part of the social capital; the choice of important buyers on the principle of political loyalties); b) the concentration of decisions about privatisation in the hands of the central governmental agency charged with putting through the process, which tended to result in corruption and the like; c) the original legislative approach left many important questions undefined and unregulated, and things were solved as they arose (the Transformation Act was amended six times); d) the lack of any appropriate computer system of monitoring privatisation in the first years of its implementation; e) the impossibility of broad social and political control of the national institutions that were under direct control of the ruling party. Along with these, the following also had an effect on the scope of the UE in privatisation: a) the war; b) the inheritance of managerial socialist self-management (in fact, delay in the privatisation of the banking system facilitated the unexpected success of the old managerial structure in privatisation, and also the consolidation of elements of the old banking management structure); c) the political design of Croatian capitalism, with the ruling party playing a role in meritocratic privatisation, in the political selection of owners, open nepotism, the conse-

quence being the cohabitation of the UE and unofficial politics, politics outside the reach of proper, constitutionally founded, institutional supervision.

- The weaknesses of the Croatian post-socialist state, such as lack of professionalism and incompetence among clerks and officials, corruption, favouritism, and particularly the overloading of the administrative, inspectorial and judicial mechanisms certainly had something to do with the existence of the UE.
- A special impetus is also probably given by the large number of small firms that are more apt to work within the UE, particularly in branches anyway prone to the UE mode of existence (in trade, financial and other services, construction). It is interesting that a large number of informal entrepreneurial activities took place in firms that belong to the official economy. The reason for this is a liberal regime and the low cost of registering companies in the interim period between the Yugoslav Companies Law and the new Croatian Companies Law of 1996.

#### *Recommendations*

Measures to suppress the UE in privatisation should be taken by: a) the government, dismissing the officials responsible; b) the police, with efficient inquiries when there is suspicion of some criminal acts; c) the judiciary, handling indictments rapidly and efficiently.

Measures against the UE in privatisation necessarily imply: a) clearer and more precise laws, which will stop arbitrariness and discretionary interpretation of the law on the part of the administration; b) the political power of the authorities publicly to condemn negative actions, and an effective judiciary; c) acceleration and speedy conclusion of the process of privatisation, thus avoiding the long term consequences or risks of corruption, fraud, bribery and so on; d) more detailed scholarly research into UE in privatisation, which requires in turn free access to data in appropriate state institutions (ministries, funds, agencies).

Economic policy directed to the suppression of the UE has to: 1) cut taxes and customs duties (to the extent the Budget will permit); 2) selectively reduce regulations; 3) reduce the role of the public sector, i.e., the state, in the economy, and liberalise the economy; 4) prompt the determination of the size of the UE in the economy as a whole, and in individual industries.

To reduce the UE it will be necessary to concentrate on: 1) explicating, making more precise, and coordinating the laws and the regulations; 2) giving the courts greater independence and making them better equipped; 3) an improvement in and better access to statistics; 4) improving the organisation, efficiency, professionalism of and cooperation among bodies of the state; 5) reduction of the role of the state, liberalisation of the economy, a more rational spending of

public money, better public sector services; 6) completion of the reform of the pensions system; 7) a break with paternalistic capitalism; 8) control of privatisation; 9) strengthening of democratic forms of control.

While attempting to reduce the UE it is more important to do away with its causes than penalise the symptoms, with the institutional sphere (the relation between the state and the economy) being of key importance.

## PART SIX

### 6.1 Welfare

#### *Basics*

Welfare transfers are budgetary and extra-budgetary allocations of funds from the public sector laid down for certain institutions and levels of government for welfare, retirement and health insurance, unemployment insurance.

#### *The situation*

High and growing expenditures for social insurance and protection in Croatia are the consequence of the large number of persons who depend on assistance from the state (pensioners, the unemployed and, in general, economically inactive persons). Croatia, like ex-Yugoslavia after all, was not a classic planned-economy. It can be said that until the beginning of the transition process, unemployment and low levels of qualifications and education were the most important determinants of poverty. In other words, the danger of marginalisation was directly linked to exclusion from the world of work. If employment or unemployment is one of the determinants of the need for welfare benefits, another one is the amount of the wage earned. In many cases low and irregular wages are an important cause of poverty.

#### *Reasons*

An analysis of welfare in Croatia is difficult because of the lack of any reliable statistical indicators, and the inconsistency of the figures that are available. Welfare programmes brought in by the new Welfare Law have in theory many desirable features. Nevertheless, the indicators available make it impossible to tell how effective they are in practice. Only on the basis of a household spending poll or some other special research programme into the level and structure of household spending will it be possible to determine how much welfare is really successfully directed to those who are truly poor and to what measure it helps them to avoid actual indigence. Thus for the moment in Croatia there are no data enabling the vertical and horizontal efficacy of the system, and one has to refrain from making any final appraisal.

## *Recommendations*

The key question of economic policy is how to bring employment in the unofficial economy into the legal framework and thus expand the base of taxpayers. This presumes re-examination of the factors that lay behind the move to work in the unofficial economy. The small number of new jobs in the official economy and moving to work in the grey zone can largely be attributed to the high level of labour costs (especially the high rates of contribution for retirement and healthcare insurance, together almost 40% of gross pay). The situation could be improved if the total rate of contributions were cut down to about 20-25%, which would correspond to the situation in OECD countries, although this would mean certain reductions of welfare rights for a given period of time. Increased hiring in the official economy, which would mean greater employment and make it easier to bear the burdens of financing public needs, would palliate the negative consequences of this reduction.

## **6.2 Financing the system for employment and reduction of unemployment**

### *Basics*

The liquidation and bankruptcy of many companies and the dismissals of large numbers of employed people combined with very limited opportunities to find a new job have resulted in an unemployment explosion in Croatia. Apart from the very large number of unemployed, there is a constant rise in the share of the long-term unemployed, i.e., those who have been waiting for more than two years for a job; almost a third of all unemployed fall within this category.

### *The situation*

The problem could be summed up in two main groups: the reduced opportunities for employment, and the relatively large number of claimants of financial benefits, so that almost all the funds available are used for meeting claims to benefits, and there is very little left over to pay for the active employment policy, their result being that there is very little going on in the way of training, retraining, additional qualifications and so on.

According to data about the structure of unemployment, in spite of the much higher rates of unemployment among the young, they in fact make up only a little more than one third of total unemployment. Persons between 25 and 50 make up 54.3% of all unemployed. For this reason, the unemployment reduction policy should not be directed only towards solving the problems of the young who find themselves outside the world of work. If the policy is designed to overcome certain unfavourable conditions, then it should be directed towards those groups that make up the majority of the people who suffer from lack of employment. On the other hand, if the point of the pol-

icy is to reduce the costs of obviating the unfavourable conditions, then it should be directed to those groups that have the highest risk of unemployment.

Although cash benefits during unemployment are small in absolute terms, the ratio between benefits and the average wage is approximately the same as in developed industrial countries. If the benefits were much higher, it would create a negative motivation about job seeking, and spring an unemployment trap.

### *Reasons*

Although in the last almost thirty years (from 1971 to 1998) the number of unemployed in Croatia has more than quintupled, the number of people in receipt of cash benefits and health insurance has increased even more, so that their proportion in overall unemployment has also increased considerably. For this reason, in the total resources of the employment system, the share taken by the provision of benefits for the unemployed has greatly risen, while the share of resources for preparation for employment has dropped, and almost all available resources in the system are spent on meeting the claims of the unemployed. In the total expenditure of the employment system in 1998, the proportion taken by benefits was 98.5%. The share of resources allocated to preparation for employment was reduced by 57% since 1971, to 1.5% in 1998.

### *Recommendations*

The labour market has the most important role in determining the living standards of the citizens of Croatia, as well as in the amounts and kinds of benefit that are supposed to be provided by the welfare organisations. A flexible labour market (with as few as possible restrictions relating to the supply of and demand for labour) with economic development can ensure a high degree of employment and a rise in wages. This would reduce the pressure on the system of welfare benefits, reduce the number of people who want to take early retirement and so on. An insufficiently flexible labour market and limitations in professional and geographical mobility only exacerbate the problems of poverty and social exclusion, and add to the burden of welfare, which is connected to the economic crisis. As well as increasing opportunities for employment, it is essential to improve the position of the unemployed by building up a suitable system of welfare for the unemployed.

Through measures of the active employment policy - training, re-training, additional training, professional qualification, the qualifications structure of job seekers will be improved, which will increase their occupational mobility and ability to become employed. At the same time, education will help the unemployed to retain the skills and knowledge they acquired earlier, forestall the possible unemployment of the still employed, and additionally coordinate supply and demand in the labour market. Mainly because of the lack of resources, training programmes for the employed and unemployed in Croatia are carried out in

very low volume. These measures in Croatia, to the greatest possible extent, should be aimed at the 15 to 24 age group, in which there is the highest rate of unemployment (and in which there is likely to be the greatest return on investment in human resources). Investment in people has to become profitable for employers, more profitable than capital investment. Secondly, to the greatest possible extent again, education and training programmes should be oriented towards jobs and qualifications for which there will be the most demand in the future, that is, the emphasis should be on qualification for known employers. This policy should be under constant review, so as to ensure its efficiency, so that the benefit should be greater than the cost, and the return greater than alternative investment in other purposes. When once the active employment policy comes to life, it is necessary to include in the training and additional training programmes an increasing number of workers and find ways of motivating them to accept new know-how and skills (increase the amount of benefit and/or extend the length of the period of benefit for those willing to undergo training).

Because of the problem of unemployment in Croatia, and from the experience of other countries in transition, it will be necessary for a certain period to increase the total sums available for employment (for active measures, preparation for employment, re- and additional qualification, as well as the passive measures, the provision of benefits) to 2 to 3 per cent of GDP.

### 6.3 Reforms of the pension system

#### *Basics*

In the whole world, pensions systems are in crisis, but there is an essential difference between the crises in the pensions systems of the industrial states, developing countries, and transitional countries. While the crises in the highly developed countries are still quite mild, the pensions systems in the countries in transition are well nigh bankrupt.

#### *The situation*

The existing public systems of pension insurance in the countries in transition are financed from current revenue and are not capable of meeting their obligations to the very large number of pensioners. Pensioners individually receive very small pensions, but the contributions for retirement insurance are extremely high (about 30%, and about 20% more for other kinds of contributions), which quite inevitably leads to shifts into the grey economy, to working "on the black". The pension system in Croatia is in a desperate situation, and as in other transition countries, it is saved from total collapse only by the fact that pensions are only partially, or not at all, made to keep up with rises in wages and the cost of living.

#### *Reasons*

There are two fundamental reasons for retirement insurance problems: demographic and financial. These reasons are in fact closely interconnected. In general, the ageing of the population (a phenomenon present in all developed countries, which needs to be separated from biological ageing) is a fundamental cause of the increased pressure upon the resources of the pension funds. This phenomenon cannot be tolerated by any economy over the long run. In 1991 the proportion of people over 65 in Croatia was 13.1% (10.1 for men, 16.0 for women). For this reason there is an inevitable trend towards the deepening of the gap between inflow and outflow, which can be solved only by greater contributions, or by the differences being made up from the Budget at the expense of other items. Neither one nor the other is desirable. Additionally, in a generational solidarity retirement system (unfunded or *pay as you go*) there is no direct link whatsoever between retirement contributions and ultimate receipts, since all payments are spent on the maintenance of today's generation of pensioners, and do not guarantee even the existing level of pension in the future, let alone any raising of the retirement standard of living. Contributions for the generational solidarity system distort not only the number of hours that an individual works, but all other features of the labour supply, like choice of profession, place of work, and investment of effort. Contributions also distort the forms and manners of payment for work, there being moves away from monetary receipts, which are taxed, to perquisites like paid holidays, winter holidays, use of an official car and so on), better work conditions and the like. At the same time, if the pensions system is very liberal (which it is not in Croatia) common sense and everyday experience say that persons who expect a high degree of income replacement will save very little for their retirement, and the system thus has a negative effect on national savings.

With the adjustment to a market economy from the early nineties in Croatia the following have come to the fore: (1) increased early retirement and disability retirement, "solving" the unemployment problem, as well as war-related disability retirement; 2) the avoidance of payment of contributions because of the flourishing of the illegal sector, moonlighting, a poor civil service, corruption and so on; (3) delays in the payment of pensions and in indexing because of lack of funds in the Budget.

In the 1980 to 1998 period, the number of insureds has decreased radically, by almost 400,000, while the number of retirees has more than doubled, so that the ratio of contribution payers to pensioners has deteriorated greatly. While at the end of 1980 there was one pensioner for every four people paying contributions, the ratio has deteriorated to such an extent that at the end of 1998 it was 1.48. This means that every three insureds support two pensioners, which is extremely unfavourable. There are most old-age pensioners in the total number of pensioners. This number increased extremely rapidly in the early 90s, when pensioning

people off was a way of managing the welfare status of people who lost their jobs because of the war or because of restructuring in the economy and who were eligible to retire, retire early, or purchase seniority.

In the 60s, 70s and at the beginning of the 80s, the average pension came to between 50 and 60% of the average wage, while the golden years for pensioners were in the 1987-1990 period, with the average pension coming to about three quarters of the average wage. After this came a fall of wages, but the cut in pensions was still more marked, and in 1993 the average pension was only slightly more than half the average wage. In the mid-90s, the growth in pensions continued to fall behind the rise in wages, so that the average pension is now constantly less than 50% of the average wage. With respect to kind of pension, in 1998 the largest were disability pensions, at 1306 kuna a month (48.7% of the average wage).

Although they figure relatively little in the total revenue of the Retirement Fund, transfers from the Budget were in the range of 0.3% of GDP (1995) to 1.98% (1997), the Retirement Fund thus becoming one of the most important generators of the deficit of the central and also the consolidated national Budget. The situation deteriorated still further in 1998 when transfers to the Retirement Fund came to about 2.75% of GDP. Croatia has actually for some time seen a rise in the Budget. A large Budget puts the brakes on economic growth, particularly in a country like Croatia with an undeveloped financial market and a weak inflow of foreign investment capital.

### *Recommendations*

In a reform of the Croatian retirement insurance system, three levels of insurance are foreseen: two obligatory levels (the first is of generational solidarity for all employees to which go contributions of 16.5% of gross wages, and a second level of capitalised savings for persons younger than 40, for which 5% of gross wages are set aside, the funds gathered being placed in privately managed pension funds), and a third level, of voluntary capitalised insurance for those who want to pay even more retirement insurance and obtain higher pensions on retirement. Apart from that, the reform foresees a gradual raising of the retirement age, an expansion of the accounting period for pension rights (which should also be a stimulus to paying contributions, for then a pension will depend directly on the amount paid in), reduction of stimuli for early retirement, and through bye-laws and better organisation an endeavour to improve the collection and the control of the collection of contributions from the private sector.

Irrespective of well-grounded criticisms (that pension reform should be done when a developed capital market, a security and bond market, a financial market, a banking system and a labour market exist in the Croatian economy; that the basic shortcoming of the proposal of the new Croatian law about the retirement

pension system is that it is not detailed enough in its regulation of the question of how and where the sums collected will be kept and made to bear interest; the question of improvement of the collection and control of the collection of contributions, and the possibility of further overburdening of the national Budget - detailed calculations for every foreseeable possibility, in terms of amounts, years and so on) retirement reform is essential and cannot be put off. On the other hand, detailed consideration of the impact of the pension system on the Budget is necessary so that long-term reliable figures can be obtained for setting the new system in a realistic budgetary framework. In addition, it is necessary to attempt to evaluate transition costs, study the consequences of changes on given age groups and coordinate pension reform with reform of the whole welfare system so that it should not happen that certain clients simply drop out of the system altogether.

Reform of the pension system is not a simple or easy task that can be accomplished overnight. Reforms that include cost restrictions are particularly difficult and need a lot of time, they mean going against certain people's interests, and today's forms of insurance have practically become sacrosanct. In Croatia it is necessary to achieve a kind of national consensus about the basic elements of the reform. It is also necessary to carry out an effective public information campaign so that the general public should be aware of the reasons behind the reform, in order to reduce the resistance that will inevitably come in the wake of such wide-ranging reforms.

## **6.4 Health insurance and the financing of health care**

### *Basics*

Health care is an expensive institution and activity that is aimed at preserving and improving health. Health protection is a wider concept than health care, because the system of health protection, apart from all the activities of the healthcare institutions, also includes other measures, aimed at preserving and improving health.

The system of financing health protection is a set of principles, regulations, mechanisms, instruments and methods through which the process of gathering the resources of health insurance and other resources of health protection goes on, as well as their distribution to those who provide health protection services. The system of financing health protection is made up of: sources of funds for financing health protection; instruments and methods for gathering resources from these sources; instruments and methods for allocating the resources that have been collected; and methods of paying those who give the services.

The market for healthcare services and insurance can be inefficient because of weak information and problems of unsuitable choice and moral hazard related to

health insurance. In all countries, healthcare costs are rising at a great rate.

### *Situation*

In terms of the number of hospital beds per 100 000 of the population, Croatia is at the level found in the more developed European countries, somewhat less so in terms of the number of physicians. Croatia earmarks a large proportion of its GDP for health, and in the early 1990s set aside the highest proportion of its GDP (8.5%) in 75 countries considered. In Croatia about 1995 the proportion given for health care increased to about 10.1% of GDP, which is just slightly smaller than the share taken by health care in Germany (10.5% of GDP).

In 1998, 4.6 million persons had health insurance (including 1.4 million members of the active working population, 160,000 active small farmers, 850,000 retirees, 200,000 unemployed and 1.8 million dependents).

### *Reasons*

Health care in Croatia is financed by a contribution of 9% on wages (paid by the employer) and 9% from wages (paid by the employee), which means that the overall rate of contribution from gross wages is 18%. These resources are collected in the Croatian Health Insurance Institute. However, the money is not enough to cover all the needs, and frequently it is impossible actually to obtain services that are theoretically available under health insurance. Difficulties with financing the health service have been going on for quite some time, and have been exacerbated since 1995, since which time spending in the health service has not been matched by appropriate revenue. Although the revenue of the CHII has been on the rise since 1996, that year ended with the Institute still owing almost a billion kuna, 1997 with debts of 2.25 billion kuna, and 1998 with over 3.76 billion kuna worth of debts. The reasons are the reduction in the number of active working people, insureds, and a rise in the number of retirees (who from February 1 1998 stopped paying any kind of contribution for health insurance whatsoever), a large nominal rise in expenditure for wages (in line with the collective agreement made in the health service, every pay rise for people whose pay comes out of the Budget automatically means a pay rise for healthcare workers), and the introduction of VAT (which cost the CHII about a billion kuna a year, with the proviso that a certain adjustment was made when VAT on medicines and implants was abolished, but only to the extent of about 330 000 kuna).

### *Recommendations*

In order to rationalise costs and improve the overall healthcare situation in Croatia, a reform of the health service is expected. It is proposed that the present system of financing almost all the health service with money that is obtained from the 18% contribution

from wages will be abolished, and that there will be three sources of resources for the medical service:

The first source would be contributions, to be reduced to 10% from the present 18%. This would lighten the load on the economy and lower the cost of labour. Of the 13 billion that the healthcare budget is expected to come to in 2000, this compulsory insurance would provide 5 billion kuna. The national Budget would also, according to current proposals, finance health care for groups at risk (children, the elderly, the unemployed and the uninsured), finance public health (epidemiology, the toxicity prevention service, radiation contamination prevention and so on), and everything that relates to preventive medicine and the promotion of good health. The third source of money would be additional or topping-up insurance, in which it is estimated that about 1.5 billion kuna would be raised to be used for all diagnostic and therapeutic services that are not provided by the national health service. The financial plan also includes money obtained from participation by insureds, which according to the current proposal would come to about 10% of the price of medical services (in the current system participation is about 1%, whereas in all European countries it is between 5 and 15%); in addition there would be a means test, which would make sure that some would not pay the participation. With this participation, and the money with which the cities and communes would co-finance their own medical institutions, another 1.5 billion kuna would find its way into the system.

Among the basic conditions for the creation of this new model of financing health protection is a precise determination of a schedule of diagnostic and therapeutic services that the patient would be guaranteed by the mandatory insurance. The first packet of obligatory services would include all that directly saves lives and forms part of the emergency services, primary health care and preventive measures. All other health care services not on this list or for a higher standard of hospital care will have to be financed from the additional insurance.

There are many advantages of the new model of financing health care. Because of the small contributions, labour costs should be reduced, which will increase the competitiveness of the Croatian economy. At the same time, citizens will be able to be directly involved in the purchase of quality medical services. To reduce spending in health care it is necessary to check on and control all operations, and diagnostic and therapeutic services, to make sure of their real necessity. Thus it is necessary to make an integrated system of *cost lists*, which would include five important categories: hospitals, prescription drugs, diagnostic procedures, the costs of treatment, and the costs of treatment at home. Apart from the reform of the financing of the health service, it is also important to design a successful national information strategy, to facilitate data exchange and appropriate evaluation of the quality of the health service in individual healthcare establishments, supervision of the effi-



ciency and financial justifiability of healthcare employees. Although reform of the health service and health insurance is not a simple or cheap task (the costs are estimated at some 40 million dollars), there are many advantages to be gained from it in the improvement of health and the health service, and the costs incurred should be far smaller than the savings made later on.

Reform of the existing system of health insurance, going in the direction of a greater reliance on private insurance and an increase of market elements, is necessary for the long-term viability of the system. This will reduce the excessive role of the state thus at once restricting the opportunities for paternalist patterns of behaviour and creating the conditions for a rise in incomes.