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NEWSLETTER



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Reforms of the Croatian Budgetary System

Since 2000, Croatia has been carrying out reforms to the old budgetary system. The objective of this paper is to cast light on the bases of the reform process in the budgetary system. This in particular refers to the new way of recording budgetary transactions, the establishment of the functions of the government treasury and the making of payments from the Single Treasury Account (STA). To this one should add the adoption of the new chart of account on which the system of financial and fiscal reporting is founded and the beginning of budgeting according to programmes, which institutions within the budgetary system are slowly mastering. We shall endeavour to explain the basic difference between the old budget system, based on the cash principle, and the new system of budgetary recording, which is based on a modified accrual system, using as an example the budget of general government and its deficit. At the end we will make some suggestions and recommendations.

Recording budgetary transactions

Right up until 2001 the emphasis in budgetary transaction records was on revenue and expenditure registered according to the *cash principle*. This means

that revenue was recorded at the time when it was collected and expenditure when it was actually paid out. In this manner a great amount of information concerning outstanding government liabilities and claims were not focussed on by the government budgetary system. Thus an important part of the information about the records of the public debt and an evaluation of the fiscal position of government were disregarded.

Since 2001 *revenue has been recorded on cash basis and expenditure on accrual basis* in the reporting period. The liability incurred is expenditure, and the accrual concept is applied only to the expenditure side of the budget (the so-called modified accrual system). Revenue is still kept on cash basis, that is, is recorded when it is collected. This concept of keeping records makes possible a more detailed monitoring of outstanding government liabilities.

Financial reporting and consolidation

Although financial statements (balance sheets, expenditure and revenue statements, and own revenue and expenditure statements) constituted the basis for the making of the budget right up to 2001, the Government and the Ministry of Finance did not make

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sufficient use of them in fiscal analysis and assessment of the financial position of government. From 2001, information from the financial statements gained in importance with the introduction of the modified accrual system of recording budgetary transactions. Since that time the substance of the financial statements has been improved as well as the scope of the information that they provide. Judging from the coverage of the information, the financial statements from 2003 will enable the budget to give a better review of government finances and to ensure the elaboration of numerous reports for decision-makers.

Consolidation. In contrast to the previous years, in 2002, the Ministry of Finance was able to consolidate the financial statements.

Consolidation - elimination of identical financial transactions among the mutually linked budgets and spending agencies and extra-budgetary users. In this manner financial data are stated as if it were a single unit concerned.

Thus the competent ministries consolidate the financial statements of their spending agencies and supply the consolidated report to the Ministry of Finance. Local government units in turn consolidate the financial statements of the spending agencies and supply these to the Ministry of Finance.

One problem is the consolidation of the financial statements of the extra-budgetary funds and companies in the public sector (Croatian Roads, Croatian Motorways, the State Deposit Security Agency, the Croatian Privatisation Fund) which do not keep the records of the financial transactions according to the accounting system of the central government budget. Hence problems do arise in the acquisition of a consolidation financial report of general government. It should be said that financial statements are drawn up quarterly, half yearly and annually.

Fiscal reporting and the account plan of the budget

Right up to 2001 and the adoption of the new chart of account of the budget, the budget was in a real sense a combination of several kinds of classification (organisational, economic, functional and programme-related) and was not a good foundation on which to draw up a budget to ensure a quality and detailed working out and analysis of government expenditure and revenue. Nevertheless, from 2001, thanks to the classification of accounts in the new chart of account, the con-

cept was changed from the ground up, abandoning the confused classification used in former years. Now, alongside the existing functional, organisational and economic we have witnessed the introduction of programme, location and fund classifications as well.

At the centre of attention are the economic and organisation classifications, the beginnings of the programme classification, and the making of the budget in terms of programmes. The application of the new chart of account of the budget will make it possible to acquire information classified into numerous categories, which will make possible a comparison and assessment of the realisation (implementation) of government policies.

Budget in terms of programmes

Since 2001 the Ministry of Finance and spending agencies have started making budgets in terms of programmes.

A programme budget shows the costs of a budget according to established programmes and those responsible for the programmes and according to kinds of expenditure. A programme budget deals with the expected results of the services and activities of government and through it the revenue and expenditure are linked with the multi-year programmes that are part of the long-term and short-term objectives and strategies of government.

The main objective of this budget is orientation to the distribution of resources in terms of programmes, activities and those responsible for these activities and a reorientation of government interests from mere allocation of resources to products, services and results. In this way a good basis is created for the evaluation of the results of given programmes of government spending.

The execution and application of a budget in terms of programmes requires additional professional training of the employees who work in the finance departments of the spending agencies at the level of central and local government. The main dilemmas are how many sub-programmes a programme may have and the enlargement of programmes outside the given ministries. For the implementation of the budget programme it is crucial for the Government clearly to lay down priority public needs programmes and the objectives of these programmes and, in collaboration with the Ministry of Finance to coordinate and monitor the financing of spending agencies in terms of programmes.

Planning budgets and revising

From 2000 to 2003, the trend of preceding years, in which revising the budget was a regular practice of government finances, was continued. The reasons for the revising of the budget should be sought primarily in new extra-budgetary funds and public enterprises being included into the central budget, the adjustment of spending agencies to the new system of recording budgetary transactions, the unrealistic plans of the spending agencies, and the existing of spending agencies' own revenue and expenditure, not included in budgetary records.

Extra-budgetary funds. As in preceding years there was no halt to the trend of creating extra-budgetary funds. The establishment of new extra-budgetary funds and the revival of old ones definitely represent a step backwards in the consolidation of the public sector. The problem is that all the extra-budgetary funds and public enterprises can create liabilities. An additional problem is that the government finances the major part of the activities of the public enterprises and of the extra-budgetary funds through transfers from the budget and by borrowing. It should be said that the Croatian Bank for Reconstruction and Development (known as HBOR) is still not included in the records of government, although government every year transfers funds to HBOR to enlarge its equity and carries out some financial functions via HBOR.

The treasury and payments from the Single Treasury Account

At the beginning of 2002, the Ministry of Finance took a step forward in the consolidation of bank accounts in domestic currency belonging to government and the centralisation of payments from the Single Treasury Account (STA). In April 2003, the Ministry of Finance closed the foreign currency accounts at commercial banks and opened a single government foreign currency deposit account at the CNB. Unfortunately, government deposits (kuna and foreign currency) are still kept at one government owned and three private banks, and not with the CNB in the STA.

Budget spending agencies closed CNB deposit accounts and opened up accounts with a commercial bank - only with the Croatian Postal Bank - for paying out cash. Now payment is carried out via special STA sub-accounts opened at the CNB for the payment of wages and operational expenditure. All expenditure is paid from the STA to the accounts of suppliers and spending agencies. The accounts are

part of the system of the government treasury. An exception is the Ministry of Science and Technology and spending agencies within it, institutions of secondary and primary education, welfare agencies and diplomatic and consular missions whose own revenue is not in the government treasury system. It is worth pointing out that the allocation of funds from the government treasury and payments from the STA are carried out according to monthly financial plans drawn up by spending agencies.

In agreement with the IMF the Government has provided for the privatisation of the Croatian Postal Bank. Thus it is still unsettled in which bank (or banks) budget spending agencies will open accounts into which the treasury will carry out payments from the STA. Manifestly, after the privatisation of the Croatian Postal Bank, the Government and Ministry of Finance will have to select on the basis of competitive bidding a commercial bank or banks, where budget spending agencies will open their accounts.

The Financial Agency, FINA, formerly ZAP, still gives information and technical support to the Ministry of Finance's government treasury system, in spite of the development within the Ministry of Finance of the government financial system based upon SAP - System, Application, Product. For this reason it is essential to abolish the duplicated provision of information about government cash transactions and to define the future status of FINA in the system of government finances, particularly after the conclusion and application of the government treasury system and payments from the STA.

Budget transparency

The report concerning the central budget is more transparent than in previous years but because of the introduction of the new classification a problem has arisen in the calculation of the budgetary deficit (current and primary) and the impossibility of seeing the financial position of government as a whole. For the Ministry of Finance the transition to the new system of the budget is a problem because the old manner of recording budgetary transactions according to the cash principle has been kept. This means that the Ministry of Finance has a double job in unifying the information. Because of the methodological switch in 2001 there was no official information even about the consolidated budget of general government, except according to the standard record of the budget according to the cash principle, which was applied before 2000.

No publicly accessible and available information about the size and structure of the consolidated budget of general government exists. The last available information relates to 1999, but only in terms of the cash principle. Even the Ministry of Finance's monthly statistical reviews are published with a time-lag of about half a year. In 2003 the IMF published a general government budget on the accrual principle (accrual principle expenditure, and revenue from privatisation in the financing account).

Although the modified accrual principle of budgetary records is officially in use, there is still no publicly available information about the size of governmental expenditure arrears. It needs pointing out that the Ministry of Finance reports to the IMF as often as quarterly about the scale of government expenditure arrears.

Spending agencies and their register

A rather difficult question in the budget system is the definition of the status of a spending agency or budgetary beneficiary. In the new Budget Law (Official Gazette 93/03) there is another curt definition of a spending agency:

Spending Agency - any public institution whose expenditure for labour and/or material costs are financed out of the budget (central or local). These are central and local government bodies (ministries, agencies, local administration), establishments (schools, kindergartens, health centres), extra budgetary funds (for development and employment, regional development, retirement, healthcare) and local self-government.

Hence definition of the status of a spending agency is not likely to be an easy task even in the future. The Government, the Ministry of Finance and the competent ministries have to determine the structure of spending agencies and the way they belong to the budgetary system. Some of the spending agencies will certainly move into the private sector (institutions in the system of health care, tertiary education and science, utilities at the local unit level). The problem is that an unclear definition of a spending agency makes it difficult to define and keep a register of spending agencies. It is necessary to define more clearly a spending agency as well as the criteria according to which institutions obtain this status. In this way the job of keeping records (registers) of spending agencies would be made considerably easier.

How to analyse the size of government and the budgetary deficit?

Budgetary revenue is recorded at the moment it is collected. Uncollected revenue (budgetary claims) is not recorded in the budget; only collection in cash is recorded. Expenditure is conducted according to accrual basis. This means the full amount of an obligation is expenditure.

Since 2003 revenue from privatisation has been recorded in the financing account and represents a receipt of the budget that is meant for the financing of the budgetary deficit. Revenue from privatisation is no longer in the category of capital revenue. According to adjustment of information in which revenue from privatisation and outstanding expenditure arrears are in the financing account (lending minus repayment), a better picture of the real size of government and of the budget deficit, as well as the way it is financed, has been obtained.

Box 1 Budget of general government according to the cash and accrual principles, in billion kuna

| | Cash 1999 | Accrual 1999 | |
|--|--------------|-----------------|---|
| Total revenue and grants | 75.0 | 68.0 | |
| Total revenue | 75.0 | 68.0 | |
| Current revenue | 68.0 | 68.0 | |
| Taxation revenue | 62.4 | 62.4 | |
| Non-taxation revenue | 5.6 | 5.6 | |
| Capital revenue | 7.0 | 0.0 | |
| Grants | 0.0 | 0.0 | |
| Total expenditure and loans minus repayments | 78.1 | 80.1 | Total expenditure increased by outstanding liabilities (2 billion kuna) |
| Total expenditure | 76.6 | 78.6 | |
| Current expenditure | 66.5 | 68.0 | Arrears for current expenditure - 1.5 billion kuna |
| Current expenditure | 10.1 | 10.6 | Arrears for capital expenditure - 0.5 billion kuna |
| Loans minus repayments | 1.6 | 1.6 | |
| Total surplus/deficit | -3.1 | -12.1 | |
| Total financing | 3.1 | 12.1 | |
| Domestic | -1.8 | -1.8 | |
| Foreign | 5.0 | 5.0 | |
| Revenue from privatisation | 0.0 | 7.0 | |
| Expenditure arrears | | 2.0 | |

Because of the transition to the new system it is necessary to show a greater level of budget deficit in the modified accrual system. Unlike the 3 billion kuna of budgetary deficit in the cash principle method, now the real level is 12 billion kuna of accrual budgeting deficit, that is, 10 billion of outstanding liabilities. According to the accrual principle budget deficit is financed by government with receipts from revenue from privatisation and borrowing at home and abroad. The level of expenditure arrears will be reduced or enlarged according to the capacity of government to cover them, which will have a direct effect on the size of the budget deficit according to the accrual principle.

Changes in the methodological coverage will be most of all reflected in the increase of the budgetary deficit. It remains unclear whether the expenditure arrears of the budget will be recorded in the financing account (lending minus repayments) or whether the Ministry of Finance will continue to keep its records according to the cash principle and use expenditure arrears in records concerning the public debt. But irrespective of the manner they are shown, an increase or reduction of expenditure arrears will certainly affect the size of the public debt.

It needs stressing that the budget of general government in the 1994 to 1999 period was not adapted to the new methodology of government finance statistics. Officially the Ministry of Finance did not work out a general government budget according to the accrual principle even in the 1999 to 2003 period.

Conclusion

Croatia may boast of having in a relatively short period of time adopted the changes in the methodology of government finance statistics and the system of financial reporting. All the processes in the budgetary system are positive and the decision makers, the Government and the Parliament, may in the near future expect a number of useful reports concerning the financial position of government. Still, after 2000, because of the methodological changes, there was almost no quality and publicly accessible information about the financial operations of government. This information gap made it impossible to carry out any broad analysis of government policies and provide an assessment of the impact of political decisions on government expenditure and on the economy. Hence in the period to come it will be necessary, aside from supporting the positive processes in the reform of the budget, to influence the decision makers in the

Government so that they publish information about government finances in conjunction with explanation about the methodological changes.

Suggestions and recommendations

- Consolidate the balance sheet of general government according to the economic classification on the modified accrual principle.
- Adjust the budgets of the previous years to the new methodology on the modified accrual principle.
- Record expenditure arrears in the public debt.
- The Ministry of Finance should work out plans for the transition to the system of payment at other banks (if the Croatian Postal Bank is privatised).
- Define the future role of FINA in the government treasury system.
- Set a clear definition of spending agency and keep a register of spending agencies.
- Stop the foundation of new extra-budgetary funds and secure the financing of all those that exist through the central budget.
- Include HBOR in the consolidation of the central budget.
- Retrain public sector employees concerning the implementation of the budget according to programmes and the recording of budgetary transactions.
- The Government, Parliament and Ministry of Finance have to provide publicly accessible information about government finances and give regular reports (monthly, quarterly, half-yearly and annually) about financial changes.

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