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Case Study (Full Report)

Quasi-Fiscal Activities in Croatia

Anto Bajo, Katarina Ott, and Irena Klemenčić, May 2014¹

Introduction

Croatia is a small country of four million people with an open economy and many public companies that have not been restructured and are dependent on state aid. State aid in Croatia still stands considerably above average EU levels. While the EU-27 member states allocated an average of 0.5 percent of GDP to aid for enterprises in 2010, Croatia allocated 2.4 times more (1.2 percent of GDP) for this purpose. Even when compared with new EU member states (EU-12), Croatia's share of state aid was twice as large as in that of the EU-12 (0.6 percent).

The state owns shares in companies defined as companies of special national interest. Thus the state's portfolio contains companies engaged in tourism, agriculture, shipbuilding, energy, and so on. Unfortunately, these companies have not been privatized, and most of their shares are not listed on the stock market. Their weak financial operations have been an ever-present threat to the fiscal position of the state. The weak financial position comes from the growing demands for borrowing guaranteed by the state through debt reprogramming, which because of the higher costs leads to the growth of the budget deficit and public debt. Unfortunately, the total fiscal costs of operations are not known; nor have the analyses and estimates by individual economic sectors been published.

In the process of transformation from a centrally planned to a market economy, numerous state-owned companies have been administratively headed by political appointees. These appointments are attractive rewards for public officials because of the very low salaries in the civil service; a position in management or on supervisory boards of companies with majority or minority state ownership provides government representatives opportunities for higher salaries and various kinds of remuneration. In many state-owned companies the presidents of supervisory boards are civil servants who have no right to remuneration. Other members of supervisory boards are either elected as a result of public job announcements or are appointed by the companies. In contrast to members of supervisory boards, appointments to management boards are political decisions because the party in power usually appoints the board president and members. In certain state-owned companies, such as shipyards, trade unions have a significant influence on management.

¹ The research for this Case Study was conducted in November 2012.

These state-owned companies (especially in shipbuilding, energy, utilities, and public radio and television services) make use of numerous subsidies, grants, government guarantees, and debt relief (especially for tax debts). Individual companies (especially energy and utility companies) have administratively fixed prices for public services at less than the actual cost of doing business. Since 2006 Croatia has liberalized the public services market and founded regulatory bodies for certain services, a consequence of Croatian accession to the EU. In the energy sector, a regulatory agency has been founded with the authority to approve changes in prices according to market developments. The decisions of this regulatory agency are binding and must be accepted by the state and local governments. This has led to the liberalization of the market and a reduction in opportunities for quasi-fiscal activities and discretionary decisions by politicians and state and local officials.

A non-transparent financial management system has been created that fosters nepotism and corruption. Companies owned by the state are not transparent, and their business reports do not allow the determination of the actual cost of doing business and thus there is no sound way to determine the size and structure of quasi-fiscal activities. Cash transactions are intertwined with many creative accounting techniques that do not clearly indicate the type, structure, and amount of some of the resulting quasi-fiscal activities or how they are settled. Many of the quasi-fiscal activities are covered by guarantees or government promises of payment, but the total amounts are unknown.

“ A non-transparent financial management system has been created that fosters nepotism and corruption.”

If the system of public financial management is to become more transparent, quasi-fiscal activities must be quantified, and the relationships between the participants specified. To determine the amounts and nature of quasi-fiscal activities, it is necessary to analyze cash flows, and in particular accounting records and property law relations between the parties.

The harmonization of Croatian legislation with that of the European Union (particularly with respect to state aid) has helped to better determine the financial relationship between the state and public companies and made it easier to recognize when certain financial instruments (loans and guarantees) are transformed into state aid. The payment of budget subsidies in Croatia is a result of, or at least clearly associated with, the harmonization of Croatian policy with EU policy under the Stabilization and Association Agreements.

In this paper, we do not deal with state financial institutions, which approve borrowing with state guarantees for development programs (such as the Croatian Bank for Reconstruction and Development and the Croatian Guarantee Agency). Most of those programs are financed through commercial banks, which have been privatized, and the funds and guarantees for their implementation are not provided by the state. Thus it is less likely that any significant quasi-fiscal liabilities will arise from those operations. The same goes for the commercial banks. In Croatia there are only two banks owned by the state and they make up only about 5 percent of total assets of the banking sector. The state guarantees citizens' deposits in those banks. By 2011 the losses of those banks have been dealt with through "silent recapitalizations" from the state budget. Financial operations of the mostly state-owned banks are under direct control of the central bank.

This paper will instead analyze and explain examples of the quasi-fiscal activities of public sector institutions – e.g., Croatian Radio and Television, shipyards, and utility companies – and give an overview of possible quasi-fiscal activities revealed by lower prices for specific user groups in the energy sector. The main reason for choosing these institutions is their dependence on state aid, their high risk of not being able to pay all debts, majority share ownership by the state, and the size of influence on management by the state and local units. The higher the share of state ownership and management, the higher the probability of quasi-fiscal activities that lead to new fiscal costs for the state and local units.

Credit Commitments and Tax Debts of Croatian Radio and Television (HRT)

The legal framework

The Law on Croatian Radio and Television (Official Gazette [OG] 137/10 and 76/12) and the statute (OG 56/11) that regulates the financing and organization of Croatian Radio and Television (HRT) were developed by HRT. These laws, in force from 2003 to 2010, said that the funding for HRT that was obtained from the state, from the provision of services and the sale of products, and from other sources belonged to HRT. According to the 2003 law, HRT was responsible for its own obligations and all its assets, with the state being jointly responsible and with unlimited liability. The obligations of HRT were supposed to be settled first from its assets and then from the budget of the state. In the new 2010 Act (amended in 2012), there is no provision for joint or guaranteed liabilities. This policy change is due to the liberalization of the market and to the announcement of the abolition of subscriptions paid by all citizens in possession of radio or television sets in their homes.

Already since 2010, the limit for license fees for public television services, known as a subscription, which must be paid by all citizens who own radio or television receivers, has been set to a maximum of 1.5 percent of the average salary in Croatia, which is determined from data from the Central Bureau of Statistics. Although this means that the amount may be adjusted, it in fact usually approaches the 1.5 percent limit. Thanks to the liberalization of the television services market, there are now new commercial television stations, which have reduced the state-owned broadcasting company's proceeds from public television advertising. Because of the global financial crisis, HRT's income from the license fee has also fallen. In addition to the reduced income from licenses and advertising, HRT has encountered the problem of high liabilities on the basis of loans which have jeopardized its liquidity.

Claims for unpaid taxes

As early as 2002, Croatian Radio and Television had liabilities for unpaid taxes. This became apparent in August 2012 when the Tax Administration announced that HRT had the second largest tax debt in Croatia.² The gradual liberalization of the market reduced the income of HRT to the point where it has been incurring losses in recent years. (See Table 1)

² HRT is a public institution that keeps records of financial operations according to entrepreneurial accounting (in line with the Companies Act), and its operation as a public institution is regulated by a special act.

Table 1 HRT Total Revenue and Expenditure 2008-2010 (in millions of Kuna)				
	2008	2009	2010	2011
Current revenue	1.538	1.564	1.463	1.414
Current expenditure	1.531	1.535	1.452	1.418
Financial revenue	11	5	10	16
Financial expenditures	14	14	37	38
Total revenue	1.549	1.569	1.473	1.430
Total expenditure	1.545	1.549	1.489	1.457
Loss/profit	4	20	-16	-27

Source: Ministry of Finance, 2012.

Because of poor financial results, total liabilities for HRT have grown from 500 million kuna in 2008 to 830 million kuna in 2011. Most of the liabilities are short term and include tax obligations and social security contributions in the amount of 171 million kuna – around 23 percent of total liabilities.³ (See Table 2).

Table 2 Tax and Social Contribution Liabilities				
	2008	2009	2010	2011
1 Short-term liabilities	387	573	552	733
2 Long-term liabilities	120	81	141	97
Total liabilities (1+2)	507	654	693	830
Tax and social contributions	49	60	147	171
Tax and contributions as % of total liabilities	10	9	21	21
Tax and contributions as % of short term liabilities	13	10	27	23

Source: Ministry of Finance, 2012.

The problem of HRT tax debt arose because of its non-payment of value added tax (VAT). The debt on the basis of VAT dates back to the period 2002-2008. The VAT debt was determined only in 2009 in light of different interpretations of the Tax Administration and HRT as to whether a public company has the right to deduct input tax. The different interpretations centered on the status of HRT as a public institution: as a state-owned company it has the right to input tax deduction, and as a public institution it must bear full tax obligation. However, HRT is a public institution, though registered as a state-owned company.

³ The current exchange rates are approximately 5.8 kuna for US\$1 and 7.5 kuna for 1 euro.

Box 1 HRT Legal Status

HRT is a public institution producing and airing television and radio programs and music productions. It is financed from many sources, including the revenues of the radio and television fee, marketing services, renting of satellite cards, the state budget, revenues from redistribution of programs on other countries' cable networks, rents, and other revenues. Based on the HRT Act (OG 17/01 and 25/03), HRT's registration has been changed from a public enterprise to a public institution. In 2002 the government passed a decision to divide the HRT into a public institution HRT and a public enterprise (a company) Transmitters and Connections Ltd. (*Odašiljači i veže d.o.o.*).

Outstanding tax liabilities are currently accounted as off-balance liabilities because they are still a matter of disagreement between HRT and the Tax Administration. In 2011 the HRT's VAT arrears (principal) alone amounted to 221 million kuna while the overall tax liabilities, with interest, reached 341 million kuna (See Table 3).

Table 3 HRT Off-Balance Tax and Total Liabilities

	2008	2009	2010	2011
VAT principal	na	na	na	221
VAT interest	na	na	na	110
Tax on profit - principal	na	na	na	5
Tax on profit - interest	na	na	na	5
Total tax liabilities	na	na	na	341
Total off-balance liabilities	345	385	467	868
Tax debt as % of total off balance liabilities				39
Off-balance sheet tax debt as % of total revenue				24

Source: Ministry of Finance and HRT financial statements, 2012.

Data from HRT reduced the profit and loss account and the balance sheet below that published on the website of the Ministry of Finance in sections on taxes, contributions, and the like. It acknowledges 159 million of debt, and lists state claims of 107 million. However, HRT is not paying its tax debts to the government, but is instead waiting for a decision from the Administrative Court.

In addition to its obligations to the Tax Administration, HRT has liabilities to suppliers and other creditors. In 2011 HRT registered a loss of 26.8 million kuna, and it has 733 million kuna in short-term liabilities (which includes existing tax debt but not tax debt recorded as off-balance) and 96 million kuna in long-term liabilities. In the same year, HRT obligations to its suppliers were 139 million kuna. In April 2012 HRT management asked the government to consent to new borrowing from commercial banks in the amount of 100 million kuna to pay off its arrears. HRT claimed that it needed the new borrowing to be able to fulfill the terms of its financial commitments. Given that HRT had contracted payment terms of 90 days and that the new Law on the Meeting of Financial Obligations (OG 125/11) provides for a period of 30 days, it is questionable whether a loan was really required to fulfill these obligations.

Information availability

Much of the information relating to the financial dealings of HRT is not publicly available. For example, for many years HRT has not published annual reports of its operations on its website.⁴ In October 2012 the government discussed the supervisory board's report, which is available on the government's website.⁵ The annual financial statements are internally discussed by the HRT Program Advisory Board, and only scattered information and summaries are available on the Internet.

The supervisory board's report to the government about its work in November 2011 revealed a number of non-transparent business practices of HRT. For example, it was not possible to control the legality of the use of fee funds and other revenues because KPMG has not distinguished between direct and indirect revenues, has not registered public and commercial revenue in separate accounts; and has not kept separate internal accounts; and HRT has not made a general act on financial operations. Unfortunately, these practices have not been corrected.

Oversight

The Croatian Competition Agency monitors state aid and publishes their findings in regular reports, the most recent of which is for the year 2010.⁶ That analysis shows that sectoral aid accounts for over 44 percent of state aid, with the largest recipients being the sectors of transportation, shipbuilding, and radio and television. HRT receives around 150 million euro annually, or about 13 percent of total allocated state aid.

		<i>In Millions of Currency</i>			<i>Percent of total</i>		
		<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>
1	Agriculture and fisheries	501	500	550	37.8	42.2	42.7
2	Industry and services	823	684	738	62.2	57.8	57.3
2.1.	Horizontal objectives	92	90	87	6.9	7.6	6.8
2.2.	Specific sectors	664	521	569	50.2	44.0	44.2
	Transport	201	178	209	15.2	15.0	16.2
	Shipbuilding	262	157	171	19.8	13.3	13.3
	Radio and television	148	154	162	11.2	13.0	12.6
	Tourism	24	22	22	1.8	1.9	1.7
	Other sectors	19	8	1	1.4	0.7	0.1
	Rehabilitation and restructuring	10	0,4	3,8	0.8	0.0	0.3
2.3.	Regional aid	43	44	42	3.2	3.7	3.3
2.4.	Aid on the local government	25	30	39	1.9	2.5	3.0
	Total	1.324	1.184	1.288	100	100	100

Source: Croatian Competition Agency, 2012.

⁴ See <http://www.hrt.hr/organizacija/>

⁵ See http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2012/57_sjednica_vlade_republike_hrvatske

⁶ See http://www.aztn.hr/uploads/documents/eng/documents/AR/Annual_report_State_aid_2010_ENG6.4.pdf

The actions of the HRT Council and the supervisory board have to be approved by the Croatian Parliament. Parliament returned the 2009 HRT Annual Report twice to be changed. Amendments to the HRT Annual Reports are published on the website of the Croatian Parliament⁷, but the last publicly available report is from November 2010 for the year 2009.

The plan of financial operations for 2012⁸ does not provide information about the potential liabilities for the repayment of debts, the amount and structure of liabilities for taxes, or the amount of rescheduled loan obligations. With the new government-appointed director of HRT in November 2012, there is hope that the new management will deal with the problem of tax debt and reduce the high costs of HRT's business activities.

State Audit

A state audit is not performed annually, but in accordance with the predetermined plan of activities of the State Audit Office, which has to be approved by the Parliament. HRT's supervisory board requested an audit in autumn 2011, but the State Audit Office replied that it does not perform audits in response to invitations. The most recent audit of HRT published by the State Audit Office goes back to 2010⁹ and there are no traces of State Audit Office reports for 2009 and 2008. The findings of the State Audit contain many comments on poor transparency of financial reports and poor records of financial transactions. An independent internal audit department has been founded, but there is no system established for reporting on the control and implementation of recommendations. For example, the manner of determining discounts on price lists for television commercials is unclear, because HRT has no records on types of customer discounts; the policies of *ad valorem* adjustments of claims and reserving have been changed; HRT has not set aside funds for tax debt repayment; and HRT has not established a computer record that could register the implementation of contracts in force.

The HRT also has to audit its annual financial reports in accordance with the Law on Auditing and the Accountancy. The new 2011 HRT Statute¹⁰ states that the financial operations of HRT will be audited by commercial auditors, but audits of the business activities of the company have been performed both by public and commercial auditors. This variance with the legal requirements is a consequence of the ambiguity and lack of transparency in the definition of the HRT's legal status. On the one hand, HRT offers marketing services and charges fees, but on the other hand it operates as a public service which charges subscriptions for public revenue.

Public Participation

Information about HRT's quasi-fiscal activities can be obtained through some public channels, mainly via the Internet. The discussions about HRT have mostly taken place within government agencies and only occasionally in the parliament, whose activities are regularly covered in broadcast media as well

⁷ See <http://www.sabor.hr/Default.aspx?art=35906&sec=3166>

⁸ See http://hrt.hr/uploads/media/Program_rada_i_financijski_plan_HRT-a_za_2012.pdf

⁹ See http://www.revizija.hr/izvjesca/2011-rr-2009/04-trgovacka_drustva/trgovacka_drustva_na_drzavnoj_razini/638_hrvatska_radiotelevizija.pdf

¹⁰ See <http://www.propisi.hr/print.php?id=11074>

as in newspaper articles and online. However, due to the lack of public access to high quality, and comprehensive information and analyses on matters of HRT's financing, it is nearly impossible to obtain an objective view of its operations.

Liabilities and Privatization of Shipyards

Financial analysis of the shipyard business is a thankless and difficult task for several reasons. First, the data on the financial performance of shipyards are patchy, confusing, and not very transparent. Second, shipyards regularly produce negative business results and registering losses greater than assets is complicated because of changes in the bookkeeping procedures for such situations.

Previously in Croatia, according to the prescribed structure of the balance sheet, capital could not be stated as a negative item. Losses in excess of total capital were divided into two different areas of the balance sheet: the amount of loss up to (but not exceeding) the total capital was recorded under liabilities (thus making the value of capital zero), and any losses in excess of capital were recorded under assets. The aim of this maneuver was balancing the balance sheet. According to a recent regulation on the structure and content of annual financial statements (OG 130/10), a loss in excess of capital is no longer to be reported in balance sheet assets; rather, the full amount is to be reported as liabilities, in the losses carried forward position (if it is from previous periods) or in the period loss position (if it is made in the current period). Losses in excess of de facto capital show a lack of assets to cover liabilities. The regulation was passed by the Committee for Accounting Standards of the Ministry of Finance¹¹.

Box 2 Committee for Accounting Standards

The members of the Committee for Accounting Standards are appointed by the government based on a proposal from the Ministry of Finance. The committee has nine members who often come from academic institutions, the Tax Administration, the State Audit Office, and so on. According to the Act and Regulation on work of the Committee for Accounting Standards, the Committee:

- analyzes and follows the development of theory and practice of accounting and financial statements;
- passes and interprets Croatian standards of financial statements;
- prepares the publication of Croatian standards of financial statements;
- publishes translations of Croatian standards of financial statements and participates in the discussion on its drafts and proposals;
- drafts and publishes standpoints about the principles of accounting system and its implementation as well as about drawing up financial statements;
- proposes the structure and contents of annual financial statements to the Minister of Finance; and
- performs other work set out by the Accounting Act.

¹¹ See <http://www.osfi.hr>

The rules of the Company Act apply to shipyards. However, the state can set different rules through regulations and special acts that create different rules of business and management for certain businesses.

According to the Bankruptcy Act, bankruptcy can be declared by a creditor or a company director if specific conditions have been met (e.g., if after 60 days the company is not able to fulfill its obligations). State-owned companies, particularly shipyards, often trust the expectations and promises of politicians (who also manage the companies) for future solutions. In the normal market environment, an unmet obligation usually leads to bankruptcy, but since no political decisions on limiting company liabilities have been made by the government, new obligations continue. In this accounting system, the obligations are registered on an accrual basis and not on a cash basis. In the system of cash basis accounting, no obligations can be paid if there is no cash in the account. When transactions are registered on an accruals basis, the emphasis is on monitoring the economy and comparing claims and obligations. The problem is that the government has not passed quality restructuring measures, nor has it limited the spending and creation of new liabilities or on the firing of employees.

Despite the audits that suggest that the operation of certain shipyards is not financially feasible without state support, they stagger forward on life-support.

The legal framework

The Act on the Organization of the Rights and Obligations of the Shipyards in the Process of Restructuring (OG 61/11), or the Shipyards Restructuring Act, regulates the rights and obligations of companies whose core business activity is shipbuilding and are undergoing restructuring to ensure their long-term sustainability in a free market. Shipyard restructuring has been implemented in accordance with the Law on State Aid (OG 140/05 and 49/11) and the international commitments undertaken by Croatia arising from the Stabilization and Association Agreement signed between Croatia and the European Communities and their Member States (OG contracts, 14/01, 14/02, 1/05, and 7/05).

“ In the normal market environment, an unmet obligation usually leads to bankruptcy, but since no political decisions on limiting company liabilities have been made by the government, new obligations continue.”

The restructuring involves four shipyards and their associated companies: 3 Maj, Kraljevica, Shipbuilding Industry Split, and Brodotrogir. The rights and obligations are set out in an individual restructuring program for each of these shipyards. There are also provisions for the restructuring of a fifth shipyard, Uljanik Pula, and its associated companies. State-guaranteed credits for these shipyards were transferred to the Croatian public debt in the amounts determined in each shipyard's restructuring program. Overdue claims relating to issued and paid state guarantees have been offset with accrued rights (counterclaims), and the remaining amounts are written off at the expense of each shipyard's resources. The tax arrears of the shipyards have been offset against their tax losses, and the remaining debt has been written off.

The Croatian government can stipulate more detailed terms, conditions, and the manner of implementation of the Shipyards Restructuring Law. By turning government guarantees to the shipyards into public debt in accordance with that law, the government legalized its previous decisions and agreements on the settlement of property relations with the shipyards.

With the adoption of the Regulation of the Rights and Obligations of the Shipyards in the Process of Restructuring (OG 61/11), the state took over the shipyards and their obligations. These obligations thus became public debt, amounting to 11.3 billion kuna or 0.01 percent of total general government debt. However, the Ministry of Finance and the Croatian National Bank statistics will not show shipyards' debts. The government will sign the shipyards' privatization agreements, and commercial banks will transfer outstanding debts from the shipyards to the state. Thus the exact amount that will become public debt will depend on the time of the completion of the restructuring and privatization of the shipyards and the contracts with the new owners.

The law provides for the tax debt of the shipyards to be written off after their balance sheets are cleared in the restructuring and privatization process. Also during this process, a fictitious profit will be shown on which the shipyards would normally have to pay tax, but which is written off in advance by this law. Unfortunately, the total actual costs of the restructuring and privatization of the shipyards are still unknown.

Because of the Shipyards Restructuring Act and creative accounting techniques, shipyards that are chronic loss-makers suddenly became profitable firms at the end of 2011. For example, the shipyard 3 Maj reported the highest accounting profits in the staggering amount of 2.6 billion kuna, and the Brodosplit shipyard reported an accounting profit of 1.6 billion kuna.

Interestingly, the government has carried out the expropriation of shipyards' assets (in accordance with a decision in February 2010); the shipyards were reimbursed the value of the assets that have become public maritime domain. The debt of the shipyards to the commercial banks was entirely covered by the state. With this uncommon accounting maneuver, the shipyards ended 2011 with a profit.

Since 1992, the government has rehabilitated shipyards on three occasions. However, it is still not known how much it will end up costing the taxpayer. In the last five years the state paid the shipyards about 12.5 billion kuna and in 2011 assumed an additional 11.3 billion kuna in its guarantees. The adoption of the Shipyards Restructuring Act created a formal requirement for new owners to take over the shipyards. The government has decided to assume all outstanding debts and contingent liabilities of shipyards, thus allowing the new owners to take over the shipyards without the old debts. The state has already paid 3.8 billion kuna of called guarantees, and now has taken on 11.3 billion kuna more of outstanding government guarantees.

According to data presentations from the Ministry of the Economy in July 2012, from 1992 to 2012 the government spent about 28 billion kuna for shipyard rehabilitation. Rehabilitation will require an additional 2.5 billion kuna from 2012 to 2017, assuming that under privatization the new owners actually shoulder their financial responsibilities.

Future obligations of the state to the shipbuilding industry are closely linked with the success of the privatization process. Now this process is the key responsibility of the new owners of the shipyards and their restructuring plans. According to the agreed government proposal, the new owners have to finance 40 percent of the cost of restructuring the shipyard.

The basis for the calculation of the costs consists of the state aid paid to the shipyards since March 1, 2006. This means that the new owners will be able to buy the shipyards for one kuna but will have to invest about 4 billion in them. However, there is still no guarantee that this is indeed the last rescue operation for Croatian shipyards. The question remains: What will happen if the new owners (who have no experience in the shipbuilding industry) fail to put shipbuilding on a sound and profitable footing? As long as the liabilities of the shipyards are covered by the State, its financial risk is as high as the risk of other commercial companies.

Box 3 Croatia's Shipyards

In 2011 enormously large profits of 5.55 billion kuna were recorded for all state-owned companies, led by the shipyards. This makes it seem that shipyards have been the main generators of economic growth in Croatia and that their restructuring processes have finally been completed. However, a verification of the annual reports submitted by the shipyards reveals contradictory information and gives a very different picture of their financial performance.

For example, the 2011 consolidated income statement of Brodosplit shows a profit of 1.72 billion kuna, ensuing from the booking of the amount of 2.51 billion kuna and underlying the Agreement Regulating Property Relations between the Government and Shipyards, which was declared as receipts from the sale of the company's fixed assets.¹² If these receipts are excluded from the operating income (as they are recorded), the company made a real loss of 777 million kuna.

According to the audited 2011 Annual Report of Brodosplit, the company's loss exceeded its capital by 2.37 billion kuna (3.72 billion in 2010). Short-term liabilities exceeded short-term assets by about 1.1 billion kuna, and total liabilities exceeded total assets by 2.37 billion kuna. Moreover the company's liabilities to the Ministry of Finance, arising from called guarantees, amounted to 1.98 billion kuna at the end of 2011 (from 2009 to 2011, the Ministry settled the shipyard's loan liabilities). Once the state guarantees have been activated, the state pays all the obligations but still claims the amount of the guaranteed obligations from the original borrower. The original borrower is obliged to repay the funds to the state budget in the amount of the paid obligation. Consequently, the accrued accounting profit of the company (1.72 billion kuna) actually represents a loss of 777 million kuna, recorded on a cash basis. Hence it is obvious that unless an efficient restructuring program is undertaken, the company's continuing operation is questionable.

Similarly in 2011 the 3 Maj Group representatives signed an agreement on the resolution of property issues with the Ministry of Economy, Labor, and Entrepreneurship.¹³ The government took over government-backed credit liabilities of 3 Maj as compensation for booked-out assets on the maritime property and assets covered by a government decision from 2000. According to the agreement, 3 Maj generated revenues of 2.9 billion kuna, which were reported in the income statement as "other business

¹² The financial statement of Brodosplit is available at <http://www.brodosplit.hr/ONAMA/Financijskaizvje%C5%A1%C4%87a/tabid/3698/Default.aspx>

¹³ The financial statement of 3 Maj is available at <http://www.3maj.hr/cm/hrvatski/brodogradevna-industrija-3-maj-d-d/izvjestaji.htm>

revenues.” But if these booked one-off revenues are excluded, the company in fact made a loss. The company's total liabilities stood at about 4.9 billion kuna, and, excluding receivables for assets under the government agreement, were 3.6 times bigger than its assets. Hence, the accounting profit of 2.2 billion kuna actually represented a monetary loss of 716 million kuna.

There is an interest for investments in shipyards through the existing five newly founded funds for economic cooperation as well as through pension funds. However, the European Commission is against the investment of funds of economic cooperation in shipyards because besides the private capital, the state also participates in the funds with minority shares. The European Commission has confirmed that the investment of the state in funds for economic cooperation has taken place on the principle of private investors. But the European Commission is not ready to accept the investments of funds for economic cooperation as a solely private investment. The problem lies not only in direct budgetary investment of the state in funds of economic cooperation but also in the fact that the state has invested in the funds of economic cooperation through its enterprises and so sees its share rise to over 50 percent. For example, in certain funds the investor is the state financial insurance company “Croatia Insurance,” but also the public Fund for Financing Degradation and Waste Management. In the existing five funds for economic cooperation, the investors are mandatory pension funds.

The purchase of the great maritime shipyards imposes one additional financial risk. This risk is the insufficiently resolved property relations between a shipyard and the state. In addition to large shipyards, Croatia also has several small shipyards, mostly located on nearby islands. Some of these small island shipyards, such as the shipyard on Ugljan, were privatized in 2000. During this privatization, the land on which the shipyard is situated became registered as its basic capital.

However, two years later, in 2002, the state decided that almost all of the land on which shipyards are situated is part of the maritime domain and must be excluded from the value of the share capital. Such a decision was made because of the large shipyards, which would enter the process of privatization more easily if their value were reduced. However, the situation is more complicated because in the case of the Ugljan shipyard, privatization was already done, and the shipyard was listed in the land register as the owner of the land. Six years ago the State Attorney made a note on the land register entry for these parcels of land stating that they are now part of the maritime domain. However, the legal issue has not been resolved because the company that owns the Ugljan shipyard went to the international court to seek compensation for the exempted maritime domain. According to market value, the land belonging to Ugljan shipyard is worth around 90 million euro. This is how much one should have in mind if the same model is to be applied when the land issues of the four big shipyards are settled.

Publicly available information

Financial statements of all shipyards are available on their websites. Unfortunately, the Croatian Parliament has never debated any of the shipyards’ annual financial reports. In the Appendix to the Report on execution of the state budget, the government delivers the report on published and active guarantees to the parliament, shown by sectors, total amounts, currencies, and creditors. The media (mainly newspapers and Internet portals) usually correctly convey information related to shipbuilding. On the government's websites there are laws and individual items of information about guarantees. On the Ministry of Finance website, there is a list of state guarantees to shipyards.

Box 4 The Legislative Framework for Government Guarantees

The legislative framework that governs guarantees in Croatia is provided by the Budget Law (OG 87/08) and the annual laws concerning the execution of the central government budget. Thus the Budget Law governs the authorities and obligations for issuing government guarantees and the annual value of new guarantees, whereas the conditions for the issuance of guarantees are governed by the annual execution of the central government's enacted budget. A *decision on the amount of government debt and government guarantees* is adopted by parliament at the recommendation of the government, in line with the amounts and purposes laid down in the annual budget and the execution of the government budget law.¹⁴ There are guarantees that the government authorizes and guarantees subject to the approval of the parliament. Except for government guarantees that are within the jurisdiction of the parliament, the government adopts a decision on issuing government guarantees for every individual guarantee at the recommendation of the Ministry of Finance. These decisions are published in the *Official Gazette*.

The Croatian Parliament approves guarantees for borrowing from international financial institutions (the EIB, EBRD, IBRD). The parliament votes in special laws for these guarantees. The amount of guarantees issued on the approval of the parliament (like guarantees issued in the current year pursuant to decisions from the previous year) do not affect the annual restriction on the issuing of new financial guarantees defined by the annual execution of the government budget laws. Most of the guarantees are issued on authorizations from the government, but there is an important amount of guarantees issued on the authorization of the parliament.¹⁵ Since 1996, two kinds of guarantees have figured in Croatia: financial guarantees and performance guarantees.

The government and Finance Ministry will issue performance guarantees on the basis of collateral in movable property that can easily be turned into cash (e.g., planes, ships, and vehicles). With such guarantees there is seldom premature collection of the whole loan or guarantee, for it is an action that is being guaranteed (i.e., the execution of a contract for the delivery of goods or services). Usually these are given on the basis of advances received in money or assets for the construction of ships up to their delivery, for the procurement of airplanes on the basis of long-term leasing contracts, and for infrastructure projects (e.g., transportation and communications, power supply, and environmental protection). Performance guarantees are recorded off the balance sheet and do not represent a burden to the loan and guarantee potential of the issuer.

In financial guarantees the government and Finance Ministry guarantee the proper servicing of loans if this is not done by the original debtor. From 1996 to 2009 the government has provided financial loans to enable borrowing by: corporations (mainly owned by the government), local government units, extra-budgetary funds, and the Croatian Bank for Reconstruction and Development. The government and

¹⁴ According to this law, government debt is defined as the debt of the consolidated budget of the government not including government guarantees.

¹⁵ Anto Bajo and Marko Primorac, "Government Guarantees and Public Debt in Croatia," *Financial Theory and Practice*, Volume 35, No. 3, 2011. http://www.fintp.hr/en/archive/government-guarantees-and-public-debt-in-croatia_313/

Ministry of Finance will issue financial loans for borrowing at home and abroad on the whole for development programs in areas of special national concern, programs for the renovation of local units, incentivizing new production, job creation and technology, preparation for the tourist season, programs in agriculture and shipbuilding, and the like.^{16, 17}

Audit

The financial operations of a shipyard are audited annually by a private auditing firm. Audit findings are available on the website of the shipyard. As of 2012 the State Audit Office has not performed financial audits of the shipyards, nor has the government discussed the shipyards' business reports before the parliament. The business of shipyards is monitored by the Croatian Competition Agency, especially in parts of business that deals with state aids.

Public Participation

The only serious scientific and financial analyses were performed at the Institute of Public Finance (IJF).¹⁸ Writings of the Institute of Public Finance have been widely quoted and commented on in print and online media, particularly those related to shipyards and public companies of local government units. Despite the fact that the IJF sends newsletters and press releases directly to national and local government authorities, the vast majority of IJF and government interactions on these issues comes in the form of individual members of government or parliament reacting to and through second-hand media reports.

¹⁶ In 1996 guarantees were issued to firms with "majority government ownership and to counties; in 1997, to firms in majority government ownership, units of local government, and extra-budgetary funds; and from 1999, to privately owned corporations. When the regulations for the criteria of issuing were passed in 2003, government loans were issued only to guarantee the obligations of public sector institutions.

¹⁷ Anto Bajo and Marko Primorac, "Do shipyards pose an obstacle for fiscal consolidation in Croatia", Newsletter, No. 64, 2011. See <http://www.ijf.hr/upload/files/file/ENG/newsletter/64.pdf>

¹⁸ See Anto Bajo and Marko Primorac, "Do Shipyards Pose an Obstacle to Fiscal Consolidation in Croatia," Institute of Public Finance, Newsletter no. 64, 2011. <http://www.ijf.hr/upload/files/file/ENG/newsletter/64.pdf>; Bajo and Primorac, "Government Guarantees"; Anto Bajo, "Companies of Special National Interest in Croatia," Institute of Public Finance, Press Release no. 25, 19 October 2010, available at: <http://www.ijf.hr/eng/releases/25.pdf>; Anto Bajo, "When Will the Government Bring Out a Report on the Financial Operations of Companies of Special National Interest?" Institute of Public Finance, Press Release no. 39, 19 July 2012, available at <http://www.ijf.hr/upload/files/file/ENG/releases/39.pdf>; Katarina Ott, "Vlada je samo skupo odgodila stečaj škerova (Government has only expensively put off the bankruptcy of the shipyards)," Tportal, 2012; and Katarina Ott, "Dospijevaju brodograđevna jamstva (Shipyards' guarantees are falling due)," Banka Magazine, 2012.

Zagreb City and Utility Holding Debt

The legal framework

Local government units in Croatia that provide public services, such as the utilities industry, set up separate legal entities or utility companies, which they control through their equity. According to the Utilities Act (OG 26/03), the utility sector includes drinking water supply, drainage and waste water treatment, gas supply, heat supply, public passenger transport, cleaning, waste disposal, maintenance of public spaces, maintenance of unclassified roads, produce markets, maintenance of cemeteries and crematoria, undertaking, chimney sweeping, and public lighting. These activities may be carried out by

companies, public institutions, services established by local government units, legal entities, and natural persons on the basis of a concession agreement or a contract to entrust utility operations to them. Funds for utility operations are provided by municipal services, utility charges, the local unit budget, and other sources according to special regulations.

The Utility Holding Company of the capital city, Zagreb, is the largest utility company in Croatia.¹⁹ Bearing in mind that Zagreb Holding is 100 percent owned by the city of Zagreb and is largely funded by earmarked revenues, we will look at the relationship between the company's and the city's budgets. This will allow us to examine the impact of the financial position of the Zagreb Holding on the city budget, which is relevant to the impact on the population, since future possibilities for the outstanding liabilities of the Zagreb Holding's budget could jeopardize the city's budget, thus leading to increased utility prices.

The principle of connected or separate vessels

Zagreb's city budget and Zagreb Holding's budget are intimately connected. The city government proposes and the city assembly adopts the budget of Zagreb Holding, but not its financial plan. Once a year representatives of Zagreb Holding submit a report to the city government for the previous business year, which the city government discusses and submits to the Zagreb City Council. Auditing of Zagreb Holding is performed by a private auditing firm, whereas the city budget audit is performed by the State Audit Office.²⁰ Usually companies are subject to commercial audits, and the budget and budgetary users are subject to state audits. The problem of determining the appropriate auditor for Zagreb Holding arises from the lack of clear criteria for distinguishing institutions of the public sector and the methods of registering their financial transactions and accountancy.

Zagreb Holding and the city function on the principle of connected vessels: the city both subsidizes Zagreb Holding and issues guarantees for its indebtedness. Local government units cannot borrow on behalf of their institutions and utility companies, but they can provide performance guarantees for companies and public institutions, of which they are founders and majority owners, without the consent of the government, according to the Instruction on the Procedure of Borrowing and Issuing Guarantees of Local and Territorial (Regional) Self-government (OG 49/2003).

¹⁹ The Utility Holding Company of Zagreb will be referred to as Zagreb Holding.

²⁰ Individual and consolidated financial reports of Zagreb Holding for the period 2006-2011 are available together with the opinion of the independent auditor at <http://www.zgh.hr/default.aspx?id=14>

Box 5 LGUs Legal Requirements for Government Guarantees

An application for consent to borrowing and for the Ministry of Finance to provide a guarantee must be submitted by the head of the local unit (head of a municipality, mayor, or county prefect).²¹ The following documents must be attached to the consent application:

The adopted budget plan for the year in which the local units are borrowing. The general part of the budget plan, with the account of revenue and expenditures, includes the financing account of the planned amounts of receipts from financial assets and from the borrowing (the amount of the credit line) and the expenditures for financial assets and the servicing of debts. All of the expenditure for the procurement of non-financial assets for which local governments assume debts and the associated amount of interest (financial expenditures) have to be included in a special part of the budget plan.

The harmonized plan of development programs. This includes the capital investment (the project), the sources of revenue for the overall performance of the investment, and a display of all the expenditures related to the investment that will burden the budget of the local unit in years to come.

The decision on the execution of the budget of the local unit. This part of the application includes the budgetary year, with the amount of the new debt and/or guarantees during the course of the budgetary year and the amount of the total debt at the end of the budgetary year.

The decision of the representative body concerning the acceptance of the investment with a clear purpose. If some investment or project is to be financed by several local units, then the Finance Ministry has to be furnished with a signed co-financing contract.

The decision of the representative body to take on debt. This contains information about the purpose of the investment (the project), the name of the bank, the amount of the credit line, the repayment period, the interest rate, the grace period, the means to secure the loan, and other costs.

Proof of the completion of the procedure for selecting the best bid. This part is required for the procurement of funding (in line with the Public Procurement Law).

Draft contract or letter of intent of a bank with the conditions for the loan. These documents should include a plan for debt servicing (amount of the loan, repayment period, interest rate, grace period, means of security, and other costs).

Certified financial reports of the local unit. These should be for the preceding year.

Calculation of amounts of operational revenues and revenues from the sale of non-financial assets collected. This information can be found in the report on revenue and expenditure, receipts, and outlays for the year that precedes the year in which the local unit is borrowing. The revenue collected should be diminished by the aid from the institutions of general government, by revenue according to

²¹ The application is submitted to the ministry's department for the preparation of the budgets of local and regional self-government.

separate regulations (local self-contributions and co-financing), and by donations from legal and natural persons.

A report concerning the repayment of previous borrowing and of guarantees made. This should be submitted along with consents to borrow at the time the application is submitted.

The state of matured but outstanding liabilities from previous years.

A report of the State Audit Office. This report will cover the auditing of the financial reports and operations.

Other financial information is to be included as well. Local units should also provide a statement of head, mayor, or county prefect accepting material and criminal responsibility for the accuracy of the documents submitted.

Table 5 Zagreb Holding Revenue from Grants and Subsidies, 2008-2011 (in thousands of kuna)

	2008	2009	2010	2011
Total grants and subsidies	804.048	851.817	777.885	711.082
1 Short-term liabilities	-	-	735.235	593.916
2 Long-term liabilities	-	-	42.650	117.166

Source: Authors' calculations, according to notes to the financial statements of the Holding for the period 2008-2011, available at <http://www.zgh.hr/default.aspx?id=14>

The data in Table 5 present Zagreb Holding's total revenues from grants and subsidies from the city for 2008-2011 and the distribution of income for ZET and other Zagreb Holding branches for 2010-2011. In 2010 about 95 percent and in 2011 about 84 percent of total grants and subsidies went to ZET, leaving only a much smaller amount for other subsidiaries in those years.

ZET has been receiving subsidies for the difference between the market price and the charged price of the tickets, factoring in the costs leasing of trams, capital grants for repayment of loan commitments guaranteed by the city, and remuneration for transportation of the unemployed according to calculations performed by the city office for Economy, Labor, and Entrepreneurship.²²

Impact of Zagreb Holding's financial position on the city budget

The extent to which the financial operations of local government units and their utility companies are interwoven necessitates further analysis of the consolidated financial statements of local government and utility companies to gain insight into the actual financial "health" of the local public sector. Due to warranties and consent given for debts, utility companies represent potential (indirect) obligations of the local units themselves. Local units may provide guarantees for the fulfillment of the obligations of companies and public institutions they own without the consent of the central government. The

²² Data available at <http://www.zagreb.hr/default.aspx?id=36038>

representative body of a local unit may issue guarantees beyond the levels permitted for local government borrowing. Furthermore, the giving of consent and guarantees for the borrowing of companies and public institutions can conceal additional borrowing by local units. Until 2010 a local unit could display debt servicing in the budget as capital donations, aid, and subsidies that it gives to institutions and utility firms that take on debt, thus circumventing the existing governmental budgetary constraints on local unit borrowing. The borrowing of Zagreb Holding is typical of the way local government units circumvent budgetary constraints.

From 2003 to 2012 the government and the Finance Ministry implemented additional yearly restrictions. In 2003 and 2004 local units could contract debt up to 3 percent of the total operating revenues; from 2004 to 2007, up to 2 percent; and since 2007, up to 2.3 percent. The cumulative budget constraint on all Croatian local government units for 2007 amounted to 430 million kuna. However, in that same year Zagreb Holding alone issued corporate bonds of 300 million euro, five times more than the total amount of borrowing allowed for the entire public sector in that year. Although such borrowing is completely legitimate because local government and utility companies are not formally linked, the Zagreb Holding debt has been largely supported by transfers from the city budget. The following are parts of the report of the State Audit Office for the year 2009 and 2010 related to capital grants of Zagreb Holding and ZET as the subsidiary with the greatest losses.

Box 6 National Audit Office: Report for 2009, City of Zagreb

In 2009, from the position of capital aid, sums for debt servicing in the amount of 141 million kuna were allocated to the subsidiary of a company owned by the city. In the period from 2004 to 2009, sums amounting to 580 million kuna were transferred to this firm for the payment of annuities and interest. This was not shown in expenditures for the repayment of loans received. In 2009, the amount of 238 million kuna was transferred to the same subsidiary in the framework of expenditure on subsidies, according to an operational leasing agreement (with 117 million referring to 2009) for payment of tram-leasing installments. It derives from this that this branch of the company was not able to meet its liabilities to service debts that the city had consented to and which the city guarantees.

To better understand the potential impact of Zagreb Holding's obligations on the financial position of the city of Zagreb, it is important to look at the direct obligations of the city and contingent liabilities in the form of guarantees given for the borrowing. For if Zagreb Holding is not able to service the debt, the city will have to do so because of its guarantees. As we can see in parts of the report of the State Audit Office in Boxes 6 and 7, the city does exactly this. Table 6 shows the net financial position of the city if all of the active liabilities came due for the period 2006-2010. During this period, the city's net financial worth ranged from 191 million to -1.5 billion kuna.

Box 7 National Audit Office: Report for 2010, City of Zagreb

Subsidies were executed in the amount of 934 million kuna. The most valuable subsidies related to grants to a subsidiary of a company owned by the city in the amount of 710 million kuna or 76 percent (co-financing of public transport — fare subsidies in the amount of 606 million kuna and repayment of lease payments for trams in the amount of 104 million kuna). Expenditures for capital grants were executed in the amount of 135 million kuna. Capital grants have been allocated to a commercial bank for repayment of subsidiary company owned by the city (for the restoration and reconstruction of the fleet) in the amount of 128 million kuna or 95 percent of total expenditures for capital grants.

The Utilities Act does not regulate the procedure of local units' bankruptcy. If they do not pay their obligations, the banks usually allow the reprogramming of their debts and the sale of assets. The government's help is expected to provide funds from the budget for the existing obligations.

In Croatia there have been cases of local unit bankruptcies in the cities of Zlatar, Trogir, and Slavonski Brod. The assets of Slavonski Brod were auctioned in order to pay debts. In Croatia the problem of unsustainable local units' finances is mostly dealt with through direct financial aid from the state.

Table 6 Net Financial Worth of City of Zagreb (in millions of kuna)

	2006	2007	2008	2009	2010
1. Financial assets	539	593	593	299	251
Cash	374	481	464	194	79
Deposits, receivables	65	60	84	64	126
Loans given	61	20	26	25	32
Securities	39	32	19	16	14
2. Direct and potential financial liabilities	349	1.713	2.102	1.747	1.623
Loans	349	350	467	509	541
Outstanding guarantees	-	1.363	1.635	1.238	1.082
3. Net financial worth (NFW)	190	-1.120	-1.509	-1.448	-1.372
NFW as % of general government debt		-1,07	-1,50	-1,23	-0,99

Source: Authors' calculations, according to the annual report for the City of the State Audit Office, available at <http://www.revizija.hr/hr/izvjesce/>

According to the Croatian National Bank (CNB), the weighted average interest rate on long-term loans indexed to companies was 5.77 percent in 2006 and 5.65 percent in 2007, while average interest rates for loans (in euros) amounted to 5.34 percent in 2006 and to 5.65 percent in 2007. In 2006 and 2007 Zagreb Holding borrowed from domestic banks on rather unfavorable terms, with the average rate of interest at around 7 percent. Zagreb Holding also borrowed from the Croatian Bank for Reconstruction and Development (CBRD) at an interest rate of 7.2 percent and from some domestic commercial banks at a rate higher than 9 percent.

One of the most favorable ways Zagreb Holding was able to secure funds was through issuing bonds on the London Stock Exchange in the amount of 300 million euros at an interest rate of 5.6 percent payable annually. Zagreb Holding did not need additional guarantees, such as those required by domestic financial institutions (e.g., mortgages on properties; issuance of debentures, acceptances, and promissory notes; and guarantees by the city).

It is not clear why Zagreb Holding had not previously borrowed by issuing bonds rather than by taking out loans on unfavorable terms from domestic financial institutions. Some 78 percent of Zagreb Holding's long-term loans are denominated in euros, exposing it to exchange rate risks. Given that 57 percent of credit liabilities have variable interest rates, the company is also significantly exposed to the risk of fluctuating interest rates. Poor liquidity ratios for 2010 and 2011 show that Zagreb Holding is unable to meet its obligations. For private companies it is not unusual for liabilities to exceed share capital; however, in the case of a company owned by the local government (and the state), which has a monopoly on the provision of public services, the burden of debt repayment is often directly transferred to users through higher costs of service. The direct transfer of burden to the citizens is seen in the example of the Zagreb Holding and ZET, which are imposing higher charges for public transport to try to cover their losses.

The Institute of Public Finance published an analysis in 2010 of the financial operations of local utility companies, which, among other things, analyzed Zagreb Holding.²³ The authors of the paper point out that the potential growth of utilities' debts, among other things, particularly exposes the residents of the city of Zagreb to risk. The ratios of income and liabilities in loans and securities are particularly unfavorable for Zagreb Holding, where only credit liabilities in excess of total revenues and total liabilities of companies grow by about 2,000 kuna per capita per year. Table 7 provides an overview of the average interest rate on debts of the Zagreb Holding.

Problems related to business cooperation between the city of Zagreb and Zagreb Holding

Table 7 Weighted Average Effective Interest Rate on the Zagreb Holding Debt, 2008-2011 (in %)				
	2008	2009	2010	2011
<i>Instruments with variable interest rate</i>				
Obligations under finance leases	7.50	5.16	3.84	4.16
Loans	7.51	5.30	4.64	5.08
<i>Instruments with fixed interest rate</i>				
Loans	6.82	6.87	6.92	7.00
Securities (bonds)	5.50	5.50	5.50	5.50

Source: Authors' calculations, according to notes to the financial statements of the Holding for the period 2008-2011, available at <http://www.zgh.hr/default.aspx?id=14>

From the official website of the Office for Economy, Labor, and Entrepreneurship for the city of Zagreb, it can be seen that between 2009 and 2011, part of the Zagreb Holding failed to respect the guidelines for economic recovery and protection of the people of the city. Also Zagreb Holding has not issued its revised business plans for 2010 and 2011, despite substantial deviations from the planned

²³ IJF's analysis of the financial operations of local utility companies is available at <http://www.ijf.hr/eng/newsletter/52.pdf>

implementation settings. The company also did not take the necessary structural measures to manage costs and balance them with realistic anticipated revenue, specific activities, responsibilities, and deadlines for remediation of the negative flows of financial operations. Zagreb Holding failed to respect the deadlines for the adoption of planning and reporting documents, ignored the executive body of the city in the preparation and completion of documentation, and did not supply the executive body of the city with minutes from meetings of the supervisory board and the general meeting of Zagreb Holding in connection with the problems. Since 2010 the mayor has not had influence on financial operations of Zagreb Holding for political reasons. Before that year, the mayor had been a member of the ruling party in the city. He then proclaimed to be independent and was expelled from the party. The party reduced the mayor's influence in the City Assembly, which controls and manages Zagreb Holding, and the employees favoring the mayor were expelled from the company's management.

The city approved the guarantees to take on debt for Zagreb Holding. Thus the city has to service the ZET debt, which was the subsidiary of the company with the largest reported loss in 2010. The interweaving of the financial operations of the city of Zagreb and Zagreb Holding requires their financial statements to be consolidated for the determination of the actual state of the city budget and its total liabilities, including state guarantees, which constitute a potential liability of the city. In the end, as happens with companies owned by the local government with a monopoly on the provision of public services, the burden of the repayment of the loan is transferred to the citizens by increases in the price of public services and by increasing debt. Unfortunately, in current budget legislation there is no formal consolidation requirement, which is the result of a lack of definition in the status of extra-budgetary users. Local utility companies are also not required to consolidate their budgetary financial statements, since they are legal entities that operate according to the law that regulates corporations.

Publicly available information

Zagreb Holding financial statements are available on its website at <http://www.zgh.hr/default.aspx?id=14>

Audit

Financial operations have been regularly audited by a private audit company. Audit opinions are public available on the Holding's web site at <http://www.zgh.hr/default.aspx?id=14>

Public participation

Daily newspapers and Internet portals regularly inform the public of matters concerning Zagreb Holding and the city of Zagreb. A few researchers have also drawn public attention to the problems of the financial management of the Holding.²⁴

²⁴ Anto Bajo, "Do Utility Companies Increase Local Government Debt?" Institute of Public Finance, Newsletter no. 28, May 2007, available at <http://www.ijf.hr/eng/newsletter/28.pdf>; Anto Bajo, "Why has the Credit Rating of Zagreb Holding Been Downgraded?" Institute of Public Finance, Press Release no. 5, 16 December 2008, available at <http://www.ijf.hr/eng/releases/5.pdf>; Anto Bajo and Marko Primorac, "Financial Operations of Local Utility Companies," Institute of Public Finance, Newsletter no. 52, December 2010, available at <http://www.ijf.hr/eng/newsletter/52.pdf>; and Marko Primorac, "Local Government and Utility Firms' Debts," Financial Theory and Practice, Vol. 35, No. 4, 2011. http://www.fintp.hr/en/archive/local-government-and-utility-firms-debts_319/

Quasi-Fiscal Activities in State-Owned Enterprises Charging Lower Prices

State-owned enterprises (SOEs) engage in quasi-fiscal activities by charging lower prices than commercial energy and utility services. Our analysis included acts and regulations regulating the field of energy: energy and regulation of energetic activities, energy for heating, oil and oil derivatives market, gas, bio fuels, electrical energy, and water supply.

The following activities at first appeared to be quasi-fiscal activities, but further research was required in order to draw these conclusions.

Reduced price of water for socially disadvantaged citizens (Article 206 of the Waters Act, OG 153/09, 63/11, 130/11)

The price of water services is set by the water supply company with prior consent from the local unit. The tariff of water supply services contains the basic price of water supply services and the price paid by socially disadvantaged citizens, which cannot be higher than 60 percent of the basic price. The Waters Act does not regulate how the difference between the basic and reduced price is to be financed. The notices on the websites of the water supply companies tell us that the 40 percent of the price is financed by subsidies from local units, based on the regulations on social security issues.²⁵ The amount of subsidies presumably corresponds to the amount of the reduction of a regular price, as no method is provided in the acts or regulations. The amounts are not included in annual reports of the enterprises.

Blue diesel

This is a special diesel fuel with added color, sold at a reduced price and intended for fishermen and farmers.²⁶ The reduced price is based on the Excise Duties Act (OG 83/09) and the Regulation on the Implementation of the Excise Duties Act Relating to Gas Oil Colored Blue for Agriculture, Fishing, and Aquaculture (OG 1/10, 44/10, 65/10, 78/10, 131/10, 144/10, 4/11, 44/11, and 134/11). The difference in the price is covered by state aid for agricultural and rural development.

Measures introduced to alleviate the growth in the price of electricity and gas for citizens and households

These price reductions are financed by state aid from the state budget, based on the Decision on implementation of Measures to Alleviate the Growth in the Price of Electricity and Gas for Citizens and Households (OG 75/08, 83/09, 81/10, 148/10) and Decision on Implementation of a Special Measure to Alleviate the Growth in the Price of Natural Gas for Households in 2011 (OG 148/10). The compensation for the price of electricity depends on the consumption of electricity and varies up to full coverage of the growth in the price for consumers with low consumption. Consumers with higher consumption pay 5-10 percent of the price growth, and the rest is covered by the state budget.²⁷ The measure was in force from 1 July 2008 until 30 June 2011 as a temporary measure introduced because of

²⁵ See <http://www.kdvik-rijeka.hr/default.asp?ru=145&gl=200512290000001&sid=&jezik=1> and <http://www.belisce.net/odgovori-na-pitanja-gradjana/>

²⁶ See http://www.hok.hr/press/novosti/cehovi/ministarstvo_poljoprivrede_nastavlja_sufinancirati_plavi_dizel; <http://www.emedjimurje.hr/201006276313/Opcenito/Novi-pravilnik-o-koristenju-plavog-dizela-u-poljoprivredi;> and <http://www.aprrr.hr/plavo-gorivo-71.aspx>

²⁷ See <http://dnevnik.hr/vijesti/hrvatska/ostaju-mjere-za-ublazavanje-rasta-cijena-struje-i-plina.html>

the increase of electricity prices. Gas consumers paid 15 percent of the increase in the price of gas, while the difference up to the full price was covered by the state budget. This measure was in force in 2011.

The price of heating and the heating services

At the end of 2012 Croatia passed a new Energy Act that fully delegates determining the price of energy-generating products to a regulatory agency. The providers of heating services are owned by the state and the local units (mostly towns). Heating companies have requested a rise of prices because they have been charging lower-than-market prices for years. Until 2012 the government and local units (towns and municipalities) decided the price of heating. Since 2012 the opinion of the regulatory agency (HERA) is binding and has to be implemented by all companies owned by local units providing heating services. Based on HERA's decision, the price will increase by 37 percent. Larger towns have announced that they will cover the price difference from the local budgets. The only problem lies in the fact that due to the financial crisis, the budgetary funds are limited, and it will be difficult to provide funds for support for heating in the budget.

“Heating companies have requested a rise of prices because they have been charging lower-than-market prices for years.”

All of the above listed activities are set out by acts or regulations passed according to the provisions of the law. The legislative procedure is completely public and can be monitored online, including legislative proposals by ministries to the government that often include prior public discussions, the proposal by the government to the Croatian Parliament, and parliamentary discussions and votes on the proposal. Proposals for laws also contain justifications of the measures and usually, but not always, a vague evaluation of their fiscal impact (usually just information on whether additional budget funds are required or not, without quantification). After legislative procedures in parliament, the full texts of acts are published in the Official Gazette and are available to all interested parties on the Internet.

The procedure of passing the regulations (including decisions and ordinances) is also fairly transparent: the ministries make a proposal to the government, which publishes the proposal on its website before the adoption, as part of the agenda for a cabinet meeting. The regulations passed by the government are published in the Official Gazette and on the websites of the relevant ministry. The regulations passed by the ministers are also published in the Official Gazette and on the websites of the ministry.

It is also important to mention that all of these activities are performed by public institutions – ministries, universities, utility companies, etc. – which are subject to State Audit Office control. These institutions are all also subject to the Right to Access to Information Act, according to which they have to publish the catalogue of the information they are responsible for and that they produce. They also have to appoint an information officer responsible to respond to any request for information within 15 days and provide the requested information. The implementation of these provisions in practice should be further researched, since, though citizens should be able to obtain information, it is possible for public institutions to fulfill the legal obligation by giving very general answers.

All other charges for services contained in the researched acts and regulations are based on tariff systems and provide full compensation of incurred costs. They all incorporate the principles of “consumer pays” and “polluter pays.”

Research into the finances of these services was particularly difficult because of a lack of transparency in both state and local budgets, as well as the SOE financial plans and reports, which contain only the cumulative sums of incomes and fees. The state and local units’ budgets enable insight into the size of overall current and capital subsidies, but not specific subsidies. Analyses of annual reports of the energy providers (gas, heating, electricity, etc.) as well as those of supervisory regulatory agencies could provide the size and the nature of quasi-fiscal activities. Those analyses require good preparatory work, a defined methodological framework, definitions of the required data, and much more time for conducting the analysis.

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