

**Republic of Croatia : Report on Observance of Standards and Codes—
Fiscal Transparency Module**

This Report on the Observance of Standards and Codes on Fiscal Transparency for the **Republic of Croatia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **November 16, 2004**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Croatia or the Executive Board of the IMF.

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REPUBLIC OF CROATIA

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

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November 16, 2004

EXECUTIVE SUMMARY

This report assesses Croatia's fiscal transparency practices in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information. The IMF *Manual on Fiscal Transparency* sets forth the terms and concepts discussed in this report. It can be found at <http://www.imf.org/external/np/fad/trans/manual/>.

Croatia meets the fiscal transparency code in a number of areas and has been making significant progress in strengthening fiscal management and transparency. The allocation of responsibilities among different levels of government generally has been well defined, and stable intergovernmental fiscal relations have been established. The Budget Act of 2003 has significantly strengthened the legal framework for budget management. The establishment of a single treasury account (TSA) has improved controls over budget execution. The new chart of accounts introduced in 2002 has facilitated the production of fiscal statistics on the general government in conformance with international standards. Legal frameworks for taxation, regulation, and administrative procedures are being harmonized with European Union (EU) standards, in conjunction with Croatia's application for EU accession.

Nonetheless, major weaknesses remain. These include weak enforcement of laws and regulations on public financial management, compromising fiscal oversight and control; extensive fiscal and quasi-fiscal activities undertaken outside the budgetary process, undermining the sound management of fiscal risks; and inadequate coordination among government agencies responsible for fiscal management, hampering fiscal accountability. Because of their important implications for fiscal management, urgent improvements needed include the government's better managing and exercising accountability over government guarantees and debt assumptions; the Ministry of Finance's (MOF) giving priority to strengthening debt management; the MOF's incorporating in the TSA government agencies of Croatian Motorways, Croatian Roads, Deposit Insurance Agency, and Croatian Privatization Fund and making the commitment registration system function effectively; the MOF's providing, with the annual budget proposal to the parliament, additional information on medium-term macroeconomic and fiscal forecasts and fiscal strategy, the policy basis of the budget, and more detailed analysis of fiscal risks; and the parliament's appropriating expenditures currently financed from certain budget users' own revenues.

Other key areas for reforms in the near term include having the government strengthen internal control of fiscal operations and the MOF enhance the transparency of tax and customs policy and administration; having the parliament more actively oversee the budgetary process; having the government improve the oversight and the reporting on public enterprises; having the MOF, the Croatian National Bank, and the Croatian Bureau Statistics reconcile their fiscal data; and having the government better coordinate among its agencies their financial oversight responsibilities.

A strong political commitment from the authorities is needed to improve Croatia's fiscal management and transparency. Such reforms and associated capacity building, supported by technical assistance as needed, are consistent with Croatia's broad strategy of moving toward EU harmonization.

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ABBREVIATIONS AND ACRONYMS

CARDS	Community Program for Assistance, Reconstruction, Development and Stabilization
CBS	Croatian Bureau of Statistics
CCG	Consolidated Central Government
CNB	Croatian National Bank
DAB	Deposit Insurance Agency
DMD	Debt Management Department
EBF	Extrabudgetary Funds
ESA95	European System of Accounts 1995
EU	European Union
FINA	Financial Agency (Payments Bureau)
FMIS	Financial Management Information System
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual
GG	General Government
HAC	Croatian Motorways
HBOR	Croatian Bank for Reconstruction and Development
HC	Croatian Roads
HFP	Croatian Privatization Fund
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPSASs	International Public Sector Accounting Standards
MOF	Ministry of Finance
PPO	Public Procurement Office
QFA	Quasi-fiscal Activity
ROSC	Reports on the Observance of Standards and Codes
Sabor	Croatian House of Representatives (Parliament)
SAO	State Audit Office
SDDS	Special Data Dissemination Standard
TSA	Treasury Single Account
USKOK	Office for the Suppression of Corruption and Organized Crime
VAT	Value-Added Tax
WB	World Bank

List of Websites

Ministry of Finance	www.mfin.hr
Croatian National Bank	www.hnb.hr
Croatian Parliament	www.sabor.hr
Croatian Government	www.vlada.hr
State Audit Office	www.revizija.hr
Central Bureau of Statistics	www.dzs.hr
Croatian Roads	www.hc.tel.hr
Croatian Motorways	www.hac.hr
Croatian Pension Fund	www.mirovinsko.hr
Croatian Health Insurance Fund	www.hzzo-net.hr
Croatian Employment Fund	www.hzz.hr
Croatian Privatization Fund	www.hfp.hr
City of Zagreb	www.zagreb.hr
Institute of Public Finance	www.ijf.hr
Central State Administrative Office for Public Administration of the Republic of Croatia	www.vlada.hr
Croatian Bank for Reconstruction and Development (HBOR)	www.hbor.hr
Croatian Chamber of Economy	www.hgk.hr
Ministry of Health and Social Welfare	www.tel.hr/mzrh/

I. INTRODUCTION¹

1. This report assesses Croatia's fiscal transparency practices against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The assessment has two parts. The first part describes Croatia's practices and has been prepared by the IMF staff on the basis of discussions with the authorities, their responses to the fiscal transparency questionnaire, and other available information. The second part is an IMF staff commentary. Assessments and recommendations are summarized in Appendix I.

II. DESCRIPTION OF PRACTICES

A. Clarity of Roles and Responsibilities

Definition of government activities

2. **The “general government” is defined consistently with the IMF *Government Finance Statistics Manual of 2001 (GFSM 2001)*, and steps have been taken to improve the coverage of the general government in the budget.** The general government includes the state institutions covered by the budget, selected extrabudgetary funds with individual budgets, and the counties, municipalities, and cities at the subnational level.² Improvements have been made to the coverage of extrabudgetary activities. Since 2001, the government has brought three extrabudgetary funds onto the budget.³ In extending budget coverage to these funds, all their non-administrative expenditure is subject to the standard appropriation controls and brought within the budget prioritization process. Despite these steps, there are a number of funds that remain outside the budget decision-making process, although their financial projections are included in the budget documents.⁴

¹ Discussions on fiscal transparency were held in Zagreb during May 5–19, 2004. The staff team comprised Ms. Kester (head), Mr. Villela (all FAD), and Messrs. Ahern and Petrie (members of the FAD panel of experts). The Resident Representative, Mr. Norregaard, and his staff provided excellent support. The mission met with officials from the Ministry of Finance (MOF); the Ministry of Sea, Tourism, Transport, and Development; the Croatian National Bank (CNB); the Croatian Development and Reconstruction Bank (HBOR); the Deposit Insurance Agency (DAB); the Croatian Roads Company (HC); the Health Insurance Fund; the Croatian Privatization Fund (HFP); the Croatian Pension Fund; the Sabor Committee on Finance and Budget; the State Audit Office (SAO); the Croatian Bureau of Statistics (CBS); the State Commission for Control of the Public Procurement Procedures; the Central State Administrative Office for Public Administration; the Finance Department of the City of Zagreb; the Institute of Public Finance; and the Economic Institute of Zagreb. The mission also liaised with representatives in Zagreb of offices of the World Bank, the European Union, the US Treasury, and the US Agency for International Development.

² A description of the subnational government is provided in paragraph 11 and in Section B of this report.

³ The Croatian Pension Fund was largely included in the budget in 2001, while the Croatian Health and Insurance Fund, and the Croatian Employment Fund were included in 2002.

⁴ They include the HAC, HC, HFP, DAB, and the Croatian Water and Environmental Protection Fund.

Box 1. General Government in Croatia

	(In percent of GDP)
General government in Croatia comprises the following:	2003
Budgetary Central Government	40.99
General public services	1.79
Defense affairs and services	2.12
Public order and safety affairs	2.68
Education affairs and services	3.53
Health affairs and services	6.01
Social security and welfare affairs and services	17.29
Housing and community amenity affairs and services	1.11
Recreational, cultural, and religious affairs	0.56
Fuel and energy related affairs and services	0.00
Agriculture, forestry, fishing, and hunting affairs	1.20
Mining, manufacturing, construction affairs	0.34
Transport and communication affairs and services	0.93
Other economic affairs and services	0.78
Expenditures not classified by major group	2.64
Extrabudgetary Funds (EBFs)	6.43
Pension fund	0.97
Health insurance fund	0.48
Employment fund	0.08
Croatian waters	0.89
Croatian motorways	2.85
Croatian roads	0.82
State agency for deposit insurance and bank rehabilitation	0.13
Croatian privatization fund	0.22
Regional and Local Governments	5.42

3. **Public enterprises carry out significant quasi-fiscal activities.** Croatia has a large public sector compared with those of economies of similar size, and a number of the public enterprises are engaged in significant quasi-fiscal activities. For example, the Croatian Railways make large losses because of regulatory restrictions on its prices, and there are quasi-fiscal activities in the public financial enterprises, as discussed in paragraph 9. This situation is changing slowly in spite of privatization activity and initial steps to bring state aid to industry in line with European Union regulations.

Government relations with nonfinancial corporations and the private sector

4. **There is a lack of clarity in the oversight responsibility on the government's holdings of fully-owned corporations and equity.** The Croatian Privatization Fund (HFP) manages a portfolio of more than 1,100 companies covering state enterprises and equity holdings outside the areas of banks, insurance companies, and utilities. The MOF has also started monitoring the financial performance of the 23 largest enterprises. In addition to the monitoring from the HFP and the MOF, enterprises established by the government report to their responsible line ministries. There is not a coordinated approach to the monitoring of the government's shareholding; and the respective roles of the HFP, MOF, and the responsible line ministries are not clear. For example, for an enterprise within the HFP portfolio, both the HFP and a responsible ministry, without distinct roles, could be involved in a request for a guarantee before it goes to the MOF. In addition, the Budget Act of 2003 requires the responsible ministry to supervise any borrowing by the enterprise even though this is a financial responsibility that the MOF monitoring role is expected to cover.⁵ It is also not always clear to the enterprises which monitoring agency has oversight responsibility over them.

5. **There are no clear regulations for profit transfers from public enterprises to the state budget.** There are no specific criteria for determining the size of dividends to be paid by profit-making public enterprises in which the government has a controlling interest.⁶ For an enterprise within the HFP portfolio, dividend is currently determined by the HFP and the enterprise.⁷ In addition, where a dividend is paid, it is retained by the HFP as its own revenue⁸ and will only be returned to the budget as part of any surplus in the HFP at the end of the year. The expenditure of the HFP is not appropriated. This approach creates mixed incentives for an agency charged with privatizing enterprises.

6. **The procedures for privatization activity are well defined, and steps have been taken to improve the transparency of the bidding and selection process.** The Privatization Law provides the HFP with a general mandate to sell the shares and interests in companies it supervises. A decision to privatize must be supported by both the HFP's management board and a government decision. For those enterprises not within the HFP portfolio, the responsible ministry has a key role in a decision to privatize. Where privatization is to proceed, the tendering process is well specified, with

⁵ See Article 65 of the Budget Act.

⁶ Even though the state has certain control over the transfers of profits through its representatives on the board of directors of the enterprise.

⁷ A similar approach is used by enterprises not monitored by the HFP; however, few of these enterprises are making profits.

⁸ See Article 10 of the Law on the Croatian Privatization Fund. The proceeds from the sale of shares and interests in companies are paid directly to the budget, unless there is a shortage in revenues for the HFP from other sources, in which case part of the proceeds may be left with the HFP.

mandated communication of the process through local media, coupled with the HFP's own efforts to promote the sale to potential bidders. Following earlier concerns over the integrity of the large-scale privatization process pursued in the first half of the 1990s, the State Audit Office (SAO) since 2002 has been given the responsibility for auditing the process. The SAO says the quality of the process has improved dramatically since that time.

7. The clarity of the government regulation of the private sector has been improved in some important areas. In recent years, new laws have been introduced in a range of areas to harmonize with EU laws. These include laws in the areas of banking, company, property, bankruptcy, competition, securities, labor, energy, taxation and telecoms. Supervision of financial institutions, the responsibility of the Croatian National Bank (CNB), has strengthened considerably. The government provides a deposit insurance function through the Deposit Insurance Agency (DAB), which is financed by commercial banks. The DAB provides insurance to individuals on account balances up to Hrk 100,000 and is building up reserves to manage this contingent liability. In addition, Article 4 (13) of the Budget Act of 2003 requires an assessment of the fiscal impact of all regulations being proposed to provide greater clarity on the fiscal implications of regulation.⁹ The Act does not require a broader cost-benefit assessment, however; and more work is required to make the objectives and application of regulation in other spheres of the economy more transparent. This particularly applies to areas in which the government has a sizable ownership interest and continues to operate price controls, such as the transport sector. In addition, while progress has been made in elements of the legal framework, more is required on the implementation and the enforcement of the laws. Moreover, the European Commission (EC) has found that the court system does not function well and does not effectively enforce creditor and property rights.¹⁰

Government relations with the central bank and public financial sector

8. The CNB has operational independence, and its financial relationship with the government is transparent. Article 53 of the Constitution states that the CNB shall be independent in its work and shall be responsible to the parliament (Sabor). This issue is further developed in the Law of the Croatian National Bank.¹¹ The CNB is not involved in quasi-fiscal activities such as subsidized lending or providing exchange rate guarantees, although the Law does not preclude these activities. While the CNB incurred significant operating losses in the past two years, the losses can be attributed to monetary

⁹ This has not been consistently implemented yet.

¹⁰ European Commission Opinion, "On the application of Croatia for Membership of the European Union," p. 48.

¹¹ Although generally positive about the level of independence provided in the Law of the Croatian National Bank, European Commission central bank legislation experts recommended some minor amendments to further increase the level of independence provided.

policy activities.¹² The proportion of profits that the CNB should distribute to the government is clearly specified in the Law. Article 36 of the Law also prohibits the CNB from providing direct credit to the government. While the government must keep the budgetary accounts with the CNB, the CNB pays the government for its deposits an interest rate comparable to that paid by commercial banks on current deposits.¹³ The CNB also acts as the government's fiscal agent for debt-servicing and provides payment-clearing services to the government through an outsourcing arrangement with the Payments Bureau (FINA). It charges the government the same amount that it pays FINA for the service.

9. Public financial institutions perform explicit quasi-fiscal activities, and the fiscal activities performed through the Croatian Bank for Reconstruction and Development (HBOR)¹⁴ have been more clearly reported by the government since 2004. The government owns two small commercial banks (Postansk Bank and Croatia Bank) and the HBOR. There are some quasi-fiscal activities associated with the banks,¹⁵ and the HBOR is exempt from tax and is expected to pursue its development objectives from the return on the Hrk 3,700 million government investment in the institution.¹⁶ The HBOR was established in 1992 to finance reconstruction in war-affected areas. Since that time its role has expanded considerably to now include business start-ups, infrastructure development, export finance, and export guarantees. This expanded scope has occurred within the frame of the original law. In addition to direct payment from the budget each year for conducting activities on behalf of the government, HBOR activities are supported by state guaranteed financing. Guarantees issued by the Republic of Croatia in favor of the HBOR include ones for the Croatian shipyards and companies that are majority-owned by the state, on which the HBOR has financial claims. These contingent liabilities have created a risk to the fiscal position either through the government's taking over the debt obligation from the HBOR's debtors directly, or through the calling of guarantees by creditors. By end 2003, debt in the amount of about Hrk 1,500 million (0.8 percent of GDP) provided by the HBOR to the

¹² The losses were due to unrealized exchange rate losses on foreign currency reserves following the significant depreciation of the US dollar.

¹³ At present, the interest rate is 0.7 percent per annum.

¹⁴ HBOR is a state-owned development bank, financed by a budget transfer and domestic and foreign borrowing. Most of the borrowing is backed by government guarantees. The HBOR is exempt from tax. The CNB includes the debt of the HBOR in both the central government debt and the general government debt; the MOF reports the HBOR debt under guarantees and does not include the HBOR under the central government or the general government.

¹⁵ For example, the government directed that all budget users hold accounts with the Postansk Bank when it started to experience financial difficulty.

¹⁶ The strategic goals of HBOR are to provide support for the reconstruction and development of the Croatian economy as well as to regionally distribute funds for the purpose of achieving balanced development of all the regions in the Republic of Croatia, with the main focus on the promotion of development in the areas of special state concern and on Croatian islands.

shipyards had been assumed by the budget. Between 2001 and 2004 HBOR disbursed loans worth Hrk 1,600 million (0.8 percent) to small and medium enterprises (SME) and the government later de facto assumed a significant part of the outstanding debt.¹⁷ In the latter case, the assumption was not accompanied by an effective claim on the debtors. The government in 2004 included in the budget as spending the disbursement (around 230 million HRK) under the SME loans assumed. In addition, the authorities decided to add the disbursements of the SME loans for previous years to spending, since the previous government had decided to assume such loans. (See also Box 3.)

Fiscal management relations among the branches of government

10. **The fiscal roles of the executive, legislative, and judicial branches are defined in the constitution and in the Budget Act of 2003.** The Constitution of Croatia (Article 90) specifies that state revenues and expenditures shall be determined by the state budget. Article 43 of the Budget Act of 2003 allows budget users to enter obligations up to the limit of funds in the budget. There is not a specific requirement for the government to seek approval from the Sabor before imposing a new tax, although by convention this is done. Under the Budget Act of 2003, the government should deliver the budget to the Sabor before November 15, and the Sabor should pass the budget within a time frame that allows the budget application to begin on January 1 of the following year. The Sabor has the ability to propose amendments to the budget provided that it is in compliance with the deficit ceiling of the government-proposed budget. Therefore, any Sabor proposal to increase an item of expenditure also must include measures to increase revenues or reduce other expenditures by the same amount. In practice, however, the requirement to identify savings in relation to the proposal is not always followed. Nonetheless, the amendment to be passed needs to be approved by the government. The vote on the budget is a confidence issue for the government.¹⁸ If the budget is not passed before the start of the budget year, there is a provision in the Act that allows temporary financing for a period of up to three months. Temporary financing for the state and local and regional self-governing units is proportional to the income earned in the same period of the previous year's budget; and the total temporary financing is not to exceed one-quarter of the total income earned during the previous year's budget.

¹⁷ These loans were extended to companies (contractors) that carried out work under the "Extended Program of Organized Reconstruction." Under the program, instead of paying the contractors directly, the government assumed the contractors' loan obligations to the HBOR. Since the government was the one that ordered the work under the program to build housing facilities for refugees and displaced persons, the loan assumption was not a form of assistance to either the HBOR or the contractors. It was a way the government met its liabilities to the contractors.

¹⁸ More than 600 amendments to the 2004 Budget were proposed by opposition legislators. The government accepted none.

Fiscal management relations among different levels of government

11. **The role of the subnational government is clearly defined.** The subnational government comprises 21 counties,¹⁹ 425 municipalities, and 122 cities.²⁰ In terms of expenditure shares as a percentage of the GDP, the consolidated state government is responsible for 48.1 percent and subnational governments are responsible for 5.3 percent.²¹ The City of Zagreb has a special status; it is both a city and a county. Its share in the tax collection and in the responsibilities for providing services to the population are defined accordingly.

12. **The laws and regulations defining the responsibilities of different levels of government provide a stable basis for intergovernmental fiscal relations.** Responsibilities of local governments are defined by the Local Governments Act of 2001 and the most important services provided by the subnational units are water supply and sewage, primary health care, and preschool and primary education. The Law on Financing Local and Regional Self-Governing Units and the specific laws on several different taxes provide the revenue framework for subnational governments. See Table 1 on the list of taxes and their assignments.²²

¹⁹ Including the City of Zagreb.

²⁰ According to the Central Bureau of Statistics.

²¹ The publicly available fiscal data on subnational governments refer to 53 major municipalities, which account for about 75-80 percent of all subnational expenditure. This issue is discussed in more detail below.

²² An important feature of the Croatian tax administration is that all taxes, regardless of their legal assignments, can be collected by the MOF's Tax Administration upon request of the local governments. Currently about 90 percent of these governments utilize the services of the MOF's Tax Administration.

Table 1. Tax Assignment in Croatia

Taxes	Jurisdiction
VAT	
Special Taxes (excises): on passenger cars, other motor vehicles, vessels, and aircrafts; on mineral oil; on alcohol; on beer; on nonalcoholic beverages; on tobacco and its products; on coffee; on luxury products; and on liability and comprehensive road vehicle insurance	National Government
Levies: on organizing lotteries, casino gambling, bookmaker gambling, and on slot-machine gambling	
Taxes on inheritance and gifts, road motor vehicles, vessels, and slot machines	County Governments
Taxes on consumption, holiday houses, trade name, use of public land, uncultivated land, unused real estate of companies, undeveloped building land, and surtax on income tax	City/Municipal Governments
Corporate income tax, personal income tax, and real estate transfer tax	Shared Among the Three Government Levels
Regulatory levy on organizing prize games for the Croatian Red Cross	Croatian Red Cross

Source: MOF – Tax Administration, *The Croatian Tax System*, Zagreb, 2003. Also available in the website www.pu.mfin.hr

13. **The tax-sharing criteria are clearly established by law.** The shared taxes are distributed among subnational governments, according to the respective tax laws.²³ In Croatia, different from many countries where the tax-sharing system is operated through a fund in budgets of higher-level governments, the distribution of the revenue of the shared taxes is primarily based on the amount collected in the city/municipality territory. Table 2 shows the destination of the revenue collected in a given city/municipality for each shared tax. An equalization fund designed to partially compensate the effects of such tax-sharing system, which clearly concentrates tax revenue in larger subnational units, receives 21 percent of the income tax revenue and is distributed according to criteria defined in laws.

14. **Subnational governments have the ability to define surtaxes levied on the income and excise taxes.** They can also define the rates of their own taxes, provided that they conform to the provisions of the Law on Financing Local and Regional Self-Governing Units and of each specific tax law.

²³ Special laws (Law on Primary and High School Education, Health, Social Care, and Firefighting) direct the transfer of certain functions and associated costs from the state to the cities (primary education and firefighting) and to the counties (high-school education, health, and social care). There is also the aid-leveling fund, whose purpose is to finance the decentralized functions of local and regional self-governing units if the units' earnings from the additional share of the income tax do not reach the amount of transferred liabilities associated with the decentralized functions.

Table 2. Tax Sharing in Croatia–2003

Tax	Destination	in percent					
		Central Government	County	City or Municipality	Decentralized Functions ¹	Fire Brigades ²	Equalization fund ³
Income		24.6	10.0	34.0	9.4	1.0	21.0
Income (Zagreb)		21.6	-	47.0	9.4	1.0	21.0
Corporate profit		70.0	10.0	20.0	-	-	-
Real Estate Transactions		40.0	-	60.0	-	-	-

Sources: MOF and Institute of Public Finance, Zagreb.

¹ Corresponds to the share of the income tax collected locally that remains in the city or municipality if it is financing decentralized functions. In cases in which the city is not financing these functions, this share of the income tax goes to the central government.

² Remains in the city or municipality that has established a fire-fighting unit.

³ Central government fund to finance transfers to poorer local governments.

15. The Budget Act of 2003 also applies to subnational governments and the budget classification is standard for all levels of government. The MOF defines general ledger accounts and accounting methodology, which are adopted by all units of the general government. The state budget guidelines are also sent to subnational governments as an input to their budget proposals, helping ensure that consistent budget assumptions are used across government levels and units. Local budget users' financial plans are also prepared with a three-year horizon and are required to follow the same structure defined in the law for state budget users.

16. Subnational government units are allowed to borrow either domestically or abroad with the approval of the MOF. The Budget Act of 2003 limits subnational borrowing to financing investment programs. Prior authorization is required both from the local/regional legislative body and from the MOF. Total debt service of a subnational unit may not exceed 20 percent of its revenue of the previous year. Once the ceiling is reached, no subnational government can borrow. Local public companies can borrow with guarantees of the government to which they belong. This borrowing is covered under the limits described above.

The legal and administrative framework for budget management

17. The Budget Act of 2003 provides a much-improved framework for the management of budget funds, but there are areas where it could be strengthened. The Budget Act of 2003 provides comprehensive guidelines on basic budget procedures at all levels of government, the roles of executive agencies and the legislature, and intergovernmental relations. The law also mandates elements of fiscal transparency by promoting the establishment of a medium-term (three-year) budget planning horizon, financial reporting, and the presentation of the budget with detailed classification (that is, functional, economic, and programmatic). However, there are a number of important areas of transparency not addressed sufficiently in the Act. For example, the required content of the budget proposal is not clearly specified. There is no requirement to present the fiscal strategy to the Sabor (both at the time that the budget guidelines are produced, and with the budget). The disclosure of fiscal risks and assessments of the sensitivity of the projections to key economic variables are also not required. In addition, Article 63 (2)

of the Act allows the government to set up funds or companies that have an arms-length relationship with the budget without recourse to the Sabor. Article 38 also gives the executive branch considerable discretion to reallocate funds across expenditure items within the budget year.²⁴

18. Debt management functions have not been formally organized. The Budget Act of 2003 includes a number of provisions to strengthen debt management. In particular, there are requirements for the Sabor to approve debt limits for each year, for the government to approve a three-year debt strategy, and for the minister of finance to approve all state borrowing and the issuance of guarantees. The monitoring of loan guarantees has also been clearly assigned to the MOF, although the assessment of credit risk continues to be performed by line ministries. Although the Act provides a clear debt management mandate to the MOF, the current organization of debt management within the MOF is weak. The responsibility for debt management is currently divided among the Debt Management Department (DMD), the Budget Execution Department, and the International Financial Institutions Department; and coordination among these units is limited. There are no formal operational guidelines on risk management. The DMD has only 50 percent of its designated posts filled and does not have a “middle office”—that is, analysis, strategic formulation, and risk control. The functionality of the current information technology system for debt management needs to be extended, and a link needs to be established with the separate system being operated by the treasury.²⁵

Legal and administrative framework for tax policy and administration

19. VAT and customs tax policies are increasingly being harmonized with EU standards, but there is a large and increasing number of exceptions²⁶ in tax statutes, diminishing transparency and certainty. The VAT Act and the Customs Act are in the process of being progressively harmonized with EU standards, although there are a number of goods subject to a zero rate of VAT. There are also a large number of exceptions to the Income Tax Act that provide benefits for specific groups. A number of additional exceptions have been introduced in the Income Tax Act in the past two years,

²⁴ According to the Budget Act of 2003, in the case of reallocations of budgetary funds (within 5 percent of expenditures and cash-outs from the changed items, if approved by the Minister of Finance), the government is to report the reallocations to the Sabor.

²⁵ Croatia’s recent Stand-by Arrangement (SBA) with the IMF aims to strengthen public debt management in a number of ways. These include: appointing by end-June 2004 a Steering Committee that will oversee the implementation of improvement measures; restructuring the MOF’s Debt Management Department by end-September 2004 (structural benchmark) and strengthening staff and training by year-end of 2004; enhancing software support by end-August 2004; and, following the recommendations of the IT expert and with support by the EU CARDS program, deciding on a permanent software solution for debt management by end-2004

²⁶ The term “exceptions” is used instead of “exemptions” because in Croatia the term “exceptions” is better understood. In addition, exemptions could be incorrect in that the special treatment in some cases may be a reduced rate of tax rather than a zero rate of tax.

some intended to assist lower income taxpayers, and others intended to promote investment. The number of exceptions reduces the transparency of the tax system. In addition, the number of amendments to the Income Tax Act in recent years, in the absence of a clear revenue policy strategy, reduces the predictability of tax policy. There is no reporting of the ongoing fiscal impact of any of these measures.

20. The MOF has primary responsibility for tax and customs policy. Both the Tax Administration Central Office and the Customs Administration are administratively part of the MOF. They also prepare estimates of the fiscal impact of tax and customs policy changes, and provide information that the MOF uses in the preparation of the budget forecasts of tax and customs revenues. They do not produce their own revenue forecasts, however, for the budget proposal. Tax refunds due to taxpayers and tax outstanding from taxpayers were reported for the first time in the 2004 budget documents. Tax arrears are not reported. Taxpayers who dispute their tax or customs duty assessments have the right to appeal to an independent administrative tribunal, and ultimately to the courts.²⁷

Civil servants' code of behavior and anti-corruption activity

21. Civil servants are subject to standards of conduct. While there is no explicit code, civil servants are bound by the rules set out in the Civil Service Law governing civil servants' behavior and the Act on Prevention of Conflicts of Interest in Public Duties. Members of parliament and state officials are required to make a declaration of their personal financial interests on an annual basis. This is filed with the Commission on Prevention of Conflicts of Interest in Public Duties. New employees are actively inducted in the standards expected of public servants. The Civil Service Law is being adapted to European standards with the assistance of the European Union's Community Program for Assistance, Reconstruction, Development and Stabilization (CARDS) project. A new law is expected to be completed later in 2004.

22. Some measures to combat corruption have been taken but more progress is required in this area. An anti-corruption strategy was developed by the government in 2001. As part of this strategy the Office for the Suppression of Corruption and Organized Crime (USKOK) was established as a dedicated enforcement agency and the agency has pursued a number of high profile cases. In addition, the Ombudsman has the role of investigating citizens' complaints of bureaucratic abuse. Since the anti-corruption strategy was released, however, many of the deadlines associated with the strategy have not been observed and international reports and surveys indicate that corruption continues to be a problem.

²⁷ The actions and decisions of all civil servants are based on the Law on General Administrative Procedure. Every administrative decision can be appealed to a second degree administrative body. If the appeal fails, it can be pursued in the Administrative Court. In addition, citizens can complain to the Ombudsman, an independent officer appointed by parliament, who investigates claims of bureaucratic abuse and reports annually to parliament on his findings.

B. Public Availability of Information

Coverage and quality of budget documents, final accounts and other fiscal reports

23. **Budget documents cover nearly all of the consolidated central government fiscal activities.** Article 18 of the Budget Act of 2003 provides that the government submit to the Sabor a state budget supported by a set of documents indicative of the government's economic and fiscal policies for the following three years.²⁸ However, the Budget Act of 2003 allows specific line ministries identified in the annual budget to retain their own revenues and make expenditures from these revenues without appropriation. Despite the steps recently taken on integrating extrabudgetary funds, there are a number of funds that remain fully outside the budget.²⁹

24. **Fiscal reports are available both for the consolidated central government (CCG) and a significant part of the general government (GG).** The consolidation of the general government fiscal reports occur in three steps: (i) line ministries and agencies consolidate their financial statements and those of their budget users; (ii) the financial statement of the state budget, the aggregate financial statement of line ministries and agencies, and the financial statements of some extrabudgetary funds are consolidated into the CCG; and (iii) CCG's and local governments financial statements are consolidated into the GG financial statements.³⁰ Local governments report quarterly to the MOF. In the MOF's monthly *Statistical Review*, subnational data are limited to the largest 53 units, comprising about 75–80 percent of total local expenditure. The MOF, however, does receive, with a lag, data from all subnational units. The MOF does not use these data for internal purposes and the data are not published.

25. **Fiscal information has recently resumed to be provided on a monthly basis for the CCG, and quarterly for the GG, and is available on the MOF's web site (www.mfin.hr/stat).** The Bureau for Macroeconomic Analysis and Planning of the MOF resumed the publication of its monthly *Statistical Review* in April 2003.³¹ The lag of these monthly data is about two months. The IMF's Special Data Dissemination Standard (SDDS) requires that monthly central government data be disseminated within a month.

²⁸ These documents refer to the Guidelines for Economic and Fiscal Policies and should contain: forecasts for the social and economic developments, fiscal and economic indicators; estimate of revenues and expenditures for all government levels; the financial plan for the previous and current years and proposals for the following three; projected changes in assets of the state, regional and local governments, and the debt of regional and local governments; and overview of the state obligations and the policy plan for the development/investment programs.

²⁹ Croatian Motorways, Croatian Roads, the Croatian Water and Environmental Protection Fund, the HFP and DAB.

³⁰ Steps (i) and (ii) are also followed by local governments.

³¹ The MOF *Statistical Review* was suspended in July 2002.

26. The government reports on operations of the general government sector, but the coverage of the sector needs to be consistent among key reporting agencies.

Fiscal statistics on the general government are produced by the MOF, Croatian Bureau of Statistics (CBS), and the CNB. However, there are differences in the coverage of the general government by these institutions. The main difference lies in the treatment of the HBOR.³² There are also differences in within-year quarterly general government reports in which the MOF uses financial reports of local government as its source while the CBS uses estimation techniques to derive its data. Under the EU's CARDS program, the CBS is coordinating with the MOF and the CNB in harmonizing the coverage of the general government in conformance with the *European System of Accounts of 1995 (ESA 1995)*.

Past and forecast fiscal data in the budget

27. The annual budget documents contain no information on fiscal outturns of previous years or forecasts beyond the budget year. There is a legal requirement for the outturn of previous years to be presented with the budget;³³ however, they were not presented in the 2004 budget proposal.³⁴ Nonetheless, historical information is provided in the annual budget execution report (referred to as "Annual Report" in Table 3), which present data on outturns and revised budget allocations for revenues, and on outturns of the two previous years for expenditures.

Nature and significance of contingent liabilities, tax expenditures, and quasi-fiscal activities

28. There is no information in the budget on existing contingent liabilities but they are partially covered in the MOF's monthly *Statistical Review*³⁵ and annual report. The annual report shows data on guarantees provided by the central government in the previous six years broken down between financial and performance guarantees. Financial guarantees are additionally disaggregated according to whether the creditor is domestic or foreign. The report also discusses guarantees by major beneficiary sectors and agencies.³⁶ There is no information, however, on cases where the government had to honor the guarantees. At the time of the mission only the MOF's annual report for 2001 was

³² While the CBS considers the HBOR to be part of general government, this view is not supported by the CNB.

³³ *Guidelines for Economic and Fiscal Policy*, Article 18, Para. 3 and Article 19, item 1.

³⁴ The MOF noted that, after the elections in November 2003, the organizational structure of budget users changed; due to technical difficulties and the lack of time, the Budget Preparation Department of the MOF did not include the revised budget of 2003 and the outturn in the government's budget proposal for 2004.

³⁵ Covering guarantees on domestic and foreign liabilities.

³⁶ However, detailed data on the guarantees approved (according to the sectors of the economy) are important for generating reports on state aids.

publicly available both in Croatian and in English. The MOF will publish its annual reports for 2002 and 2003 in a single volume. (See also paragraph 40 and Box 3.)

29. **There is no reporting on tax expenditures and quasi-fiscal activities.** However, both the tax and the customs administrations estimate, upon request, the impact of proposed legislative changes on the revenues of taxes or custom duties. They are capable of regularly estimating the revenue forgone in relation to existing exemptions and other similar waivers. Quasi-fiscal activities are not reported either in fiscal documents or other documents of the central government, or in the annual reports of public enterprises.

Publication of data on debt and financial assets

30. **The central government reports regularly and on a timely manner on its gross debt level and composition.** Annual and semiannual reports from the government to the parliament provide a detailed description of both domestic and foreign debt in the form of bonds. Information on outstanding bond stock, maturity, interest rate, currency, and payment schedule is provided by instrument and series of issues. Domestic bonds issued by government agencies with guarantees of the government are included in the consolidated debt. The monthly *Statistical Review* by MOF and the monthly CNB *Statistical Bulletin* separately compile and publish these data. General government debt stock is also presented in these monthly reports. Data related to the consolidated central government are updated monthly, while data on the 53 largest municipalities are updated quarterly. There is, however, little information on state loans obtained from banks (long term and short term).³⁷ There is also no systematic monitoring of state enterprise debt.

31. **There is no reporting on government financial assets.**³⁸ Year-end financial statements are required by the Budget Act of 2003 to include a balance sheet statement. Despite the internal availability of balance sheets of budget users in the MOF, it does not release information on the consolidated central government balance sheet.³⁹ There is no indication that MOF has plans to publish this information in the near future. (See also paragraph 4.)

Commitment to the publication of fiscal information

32. **The Budget Act of 2003 requires that the annual statement of budget accounts be prepared by the state and local governments, including extrabudgetary funds (EBFs), and sent to the SAO and to the parliament.** The MOF and local governments' financial bodies have to submit draft annual statements to the government or to the local executive bodies by May 1. These reports have to be submitted both to the SAO and to the parliament and published in the official gazettes; the Budget Act of 2003, however,

³⁷ There is also little information on domestic currency debt; such debt, however, is not significant in Croatia, where the euro is widely used.

³⁸ There is also little information on government fixed, tangible, and physical assets (buildings, land, etc.).

³⁹ There is also the need to consolidate the data on assets and liabilities of the government.

does not establish deadlines for these submissions or publications. On the budget execution, the Budget Act requires that semiannual statements be submitted to the parliament by August 5.

33. **A six-month advance calendar is provided in the MOF monthly *Statistical Review*.** There is no legal obligation to release fiscal data on specific dates. However, Croatia subscribes to the SDDS, which requires that an advance release calendar for fiscal data be published. The data are to cover general government operations (released quarterly), central governments operations, and domestic debt (both released monthly). These data are disseminated through the MOF's monthly *Statistical Review* and also posted on its website.

Table 3. Regular Government Reports containing Fiscal Data

Institution	Report	Contents	Frequency
MOF	<i>Statistical Review</i>	CG and CCG budget outturns and debt stock; GG budget outturns and debt stock ¹ ; Treasury bill auctions	Monthly
	<i>Annual Report</i>	CG, and CCG budget and budget outturns; GG budget outturns; CG tax and non-tax revenues; CG functional classification of expenditures; financing and expenditures of local governments; CG, CCG, and GG debt; and guarantees of the Republic (latest issue available 2001).	Annual
CNB ²	<i>Statistical Bulletin</i>	External debt by domestic sectors; external debt by creditors; external debt by domestic sectors and projected future payments; CG and CCG fiscal operations; and CG debt	Monthly
	<i>Annual Report</i>	Same as above	Annual
CBS ²	<i>Statistical Report</i>	government consumption and expenditure ¹	Monthly
	<i>Annual Report</i>	CG, CCG, and GG budget outturns	Annual

Source: MOF

¹ Quarterly data

² This table refers only to the fiscal data published by these institutions.

C. Open Budget Preparation, Execution, and Reporting

Openness and clarity of the budget preparation and approval process

34. **The steps in the annual budget process are set out in the Budget Act of 2003, but provide for limited involvement of the Sabor.** The key stages in the budget preparation and approval process for all levels of government are clearly set out. Box 2 below describes the main steps. The general election in late 2003 meant that the 2004 budget did not follow the latter stages of the prescribed process. The 2004 budget proposal of the incoming government was presented to the Sabor in February 2004 and adopted in March 2004. While the main steps in budget preparation within the executive branch are set out in the Act, there is no formal provision or opportunity for the Sabor to discuss the budget strategy, set out in the Budget Guidelines and adopted and issued to line ministries by the government in midyear, prior to presentation of the final budget proposal to the Sabor in November of each year.

Box 2. The Budget Preparation Process		
Due dates	Activities	Legal basis*
The fiscal year is set on a calendar-year basis by the Budget Act, which also allocates responsibility for planning the budget to the ministry of finance. The main steps in the process are as follows:		
By end-April	Medium term economic and fiscal outlook prepared by MOF and presented to government.	Article 18(2)
By mid-May	Government enacts budget guidelines.	Article 18(4)
By end-May	On the basis of the guidelines, MOF issues instructions to budget users and extra-budgetary users of the State budget, and to local and regional self-government units, for the development of the State budget proposal.	Article 20(3)
By end-June	Budget users deliver their financial plan proposals to the responsible ministry.	Article 22(2)
July–October	MOF (or the administrative body of finance of the local and regional self-government) reviews the proposals, and reconciles them with the estimated revenues and receipts. Detailed negotiations between MOF and the responsible ministries.	Article 30(1,2)
October 15	MOF prepares the draft State budget and draft consolidated budget and delivers to the government. The administrative bodies of finance of the local and regional self-government prepare draft budgets and draft consolidated budgets and deliver them to the local executive body.	Article 30(4)
Late October	Government deliberation and decision over final budget proposal, on the basis of competing proposals from MOF and line ministries.	Administrative
By November 15	The government (or sub-national executive body) delivers the budget proposal and the consolidated budget to the Sabor (or local legislative body).	Article 30(5)
By end-December	The Sabor (or sub-national legislative body) shall pass the budget.** The approved budget is published in the Narodne Novine (National Official Gazette)	Article 32(1,3)
*References to Articles are to the Budget Act 2003. **The 2004 budget was not passed by the Sabor until March 2004, due to the impact of the general election in November 2003.		

The macroeconomic framework and policy basis for the budget

35. The macroeconomic forecasts are prepared increasingly with the use of a consistent framework and a range of sectoral and macroeconomic data. The macroeconomic forecasts on which the budget has been based in recent years are one-year forecasts only, although the Budget Guidelines for 2005 were based on a three-year macroeconomic forecast. The forecasts are prepared by the Bureau for Macroeconomic Analysis and Planning in the MOF.⁴⁰ The budget proposal presented to the Sabor is based on macroeconomic forecasts prepared in April. While these forecasts may subsequently be adjusted in an ad hoc manner on the basis of economic

⁴⁰ Some of the forecasting assumptions were included for the first time in the budget documents presented to the Sabor in November.

developments during the year, there is no formal update of the macroeconomic forecasts prior to finalization of the government's budget proposal in November.

36. The fiscal forecasts presented with recent budgets were for the budget year only, and there was limited discussion of medium-term fiscal policy objectives. The Budget Guidelines in June 2003 contained only a brief indication of the government's fiscal policy priorities for the 2004 budget, and the budget presented to the Sabor referred only to the general goal of fiscal consolidation. The government has not separately published in recent years any medium-term quantitative or qualitative discussion of fiscal prospects or sustainability, although three-year fiscal forecasts are being prepared for the 2005 budget, as required by the Budget Act 2003. Official longer-term projections of pension spending have been published on an ad hoc basis in recent years, but these have not been integrated into any overall assessment of fiscal sustainability. The MOF did, however, commission the Zagreb Institute of Economics to produce a quantitative analysis of debt sustainability, which has recently been published.⁴¹ The government has also authorized the public release of International Monetary Fund documents containing quantitative discussions of fiscal strategy and sustainability, in the context of Croatia's Standby Arrangement with the Fund.

37. It is difficult to determine from the budget presented to the Sabor what new revenue and expenditure policies are being proposed. During budget preparation, the government does not receive explicit advice on what its fiscal deficit target implies for the amount of expenditure compression required within sectors, and for the achievement of the government's expenditure policy objectives. That is, there is no explicit assessment and explanation of what specific spending cuts or changes will be required in order to achieve the targeted fiscal deficit. After the government decides in late October what the overall deficit will be and the ceilings for each line ministry, line ministries have been left to decide in recent years how to allocate the cut within their budget. There is no discussion in the budget presented to the Sabor in mid-November of what changes budget users and extrabudgetary users will have to make to current service levels to manage within their proposed budgets. It is therefore difficult for the Sabor and the public to appreciate what expenditure policy changes are being proposed in the budget. There is also no comprehensive presentation of the revenue policy changes being introduced in the budget together with their expected fiscal effects.

38. Beyond an allowance for unexpected spending and calls on guarantees, there is no information presented with the budget on fiscal risks. The Budget Act of 2003 authorizes a budgetary reserve of 0.5 percent of revenues to be used to meet unpredicted payments such as natural disasters.⁴² The budget also contains a guarantees fund to meet

⁴¹ See A. Babic, I. Krznar, D. Nestic and S. Svaljek, *Dynamic Analysis of Croatia's Fiscal and External Sustainability: Application of Standard Financial Indicators*, in *Economic Trends and Policy*, No. 97, Winter 2003, pp. 77–125.

⁴² The Government is required by law to report to the Sabor semiannually on their use.

the annual expected cash cost of guarantees called and sets a quantitative ceiling on the total face value of new guarantees issued by the central government during the budget year. However, there is no information accompanying the budget that would allow some assessment of whether the guarantees fund is likely to be broadly sufficient (such as data on the outstanding stock of active government guarantees, and on past calls on guarantees). In addition, while the main macroeconomic assumptions underpinning the budget forecasts are presented, there is no information on the sensitivity of budget estimates to changes in economic variables, such as GDP growth or interest rates.

39. There is a lack of transparency with respect to the use of guarantees.⁴³

Guarantees are being systematically used to circumvent budget discipline. The outstanding stock of guarantees reported as at December 2003 was equivalent to nearly eight percent of GDP.⁴⁴ The 2004 budget approved by the Sabor authorizes the minister of finance to issue new guarantees up to an amount that is equivalent to five percent of total consolidated central government expenditure.⁴⁵ There is no other link between the budget process and decisions to grant guarantees, and no assessment of whether a guarantee is a more cost-effective instrument than a direct government expenditure, subsidy, or loan. Budget users and public enterprises whose budget or subsidy for the following year is cut may apply successfully during the next year for a guaranteed loan, rather than fully adjusting their activity levels down. The expenditures of guarantee recipients that are financed by guaranteed loans are not authorized in advance by parliament. When a guarantee is called, the assumption of debt is not further authorized by parliament. There is inadequate information on the stock of active guarantees and on calls on guarantees, and it is not possible to identify from the government's debt reporting what portion of the increase in government debt in any given year is due to the assumption of debt under called guarantees.⁴⁶ The interest rate paid on government-guaranteed loans, which is not publicly reported, is typically significantly

⁴³ There is also incomplete information on other forms of state aid (see also paragraphs 3 and 9).

⁴⁴ The MOF, during the second half of 2003, at the request of the IMF, developed a guarantee register for guarantees issued by the central government to entities inside and outside the general government (including guarantees covering the HBOR borrowing and lending), disaggregated into foreign and domestic. For each year, the register would list guarantees contracted and outstanding amount at the time of reporting. Based on this broader coverage of contingent liabilities, the outstanding stock of guarantees at end of 2003 amounted to about 11 percent of GDP. The new stand-by arrangement (SBA) under consideration by the Fund calls for the completion of the register by end-2004 with inclusion of local government guarantees and their reconciliation with data compiled by the CNB. The SBA under consideration also calls for limits on guarantee issuance.

⁴⁵ Croatia's Stand-by Arrangement (SBA) with the IMF imposes a ceiling on the nominal stock of guarantees (unchanged) to entities outside of the general government by limiting new issuance to the amortization of existing guaranteed loans.

⁴⁶ The Budget Act incorporates two definitions of debt: government debt, which is consolidated central government debt without guarantees, and public debt, which is government debt plus government guarantees. When a guarantee is called, it is not reported as being reclassified from guaranteed debt to government debt, and public debt as defined is unchanged.

higher than the government's own borrowing cost. Box 3 describes the processes by which guarantees are granted and managed in Croatia.

40. There is also a lack of transparency with respect to the assumption of debt by the government. The government has, in recent years, assumed the debt of public enterprises and of that owed to the HBOR (for example, the HBOR lends to medium and small enterprises under the reconstruction program and a significant proportion of these loans are not repaid to the HBOR).⁴⁷ Debt assumption has not been reported to the parliament at the time it takes place. There has not been a published reconciliation explaining the reasons for the change in government debt between the beginning and the end of the year, and apportioning the amount of the change to the fiscal deficit, assumption of debt, and other reasons.

41. Budget data are presented mainly on a gross basis, and classifications conform to international standards. Expenditures are mainly shown on a gross basis. Although the own revenues of many entities have been brought on budget in recent years, the Budget Act of 2003 allows specified entities to spend own-revenues off-budget, and these entities are named in the annual *Budget Execution Law*. Neither the level of these own revenues, nor the expenditures they finance are publicly reported. Expenditures are shown in the budget by administrative unit, and the chart of accounts enables reporting of expenditures by economic classification that conforms to the IMF's *Government Finance Statistics Manual of 2001 (GFS 2001)*. No functional classification of expenditures is presented in budget documents, although it is a requirement of the Budget Act of 2003.⁴⁸ The categorization of revenues and financing conforms to international standards.

⁴⁷ According to the HBOR, instead of making direct payments to the contractors who borrow from the HBOR, the government assumed the portion of the contractors' loan obligations to HBOR. This assumption of debt is less than transparent.

⁴⁸ The most recent publicly available report of government spending by function is for the 2000 year, in MOF's 2001 Annual Report.

Box 3. Guarantees in Croatia

The annual Budget Execution Law sets a ceiling on the face value of new guarantees the central government may issue in the following year. Each guarantee must be approved by the minister of finance, on the basis of criteria set out in the Budget Execution Law. These criteria include that the guarantee recipient must have made a profit in the most recent year, and can provide sufficient collateral. The annual budget also contains a line item (the Guarantees Fund) to meet the estimated cash cost in the next year of making ongoing payments under called guarantees. It is not clear how the amount of the Guarantees Fund has been estimated. For instance, there is no information in the budget documents on the total value of outstanding guarantees, or on past calls.

The Guarantees Fund is used to meet the cost of ongoing payments with respect to: (a) calls that were exercised in the previous year and that have been carried forward to be charged against the current year, and (b) new calls. When a guarantee is first called, the resulting ongoing expenditure will be a charge against the Guarantee Fund for the remainder of that fiscal year. At the end of the year, an assessment is made of all calls newly exercised that year to determine the prospect that the original debtor may be able to resume their obligations. On the basis of that assessment, expenditures on ongoing calls are either reclassified as official debt servicing, or remain as a charge against the Guarantees Fund in the following year.

When a guarantee is called, the Budget Act requires the government to establish a claim against the original debtor. In practice, this claim is often waived by a decision of the minister of finance.

New guarantee proposals originate with line ministries or public enterprises. Approval may be sought at any time of the year, and the approved ceiling on new guarantees is allocated on a first come first served basis. All proposals for guarantees must first be assessed by the responsible line ministry. They are then forwarded to the debt management unit in the MOF. They are not assessed by staff involved in budget preparation or public enterprise monitoring, and there is no connection with the budget process (other than the levying of a uniform one-off fee of 0.5 percent of the face value, which is a revenue of central government). All decisions to issue new guarantees are published monthly in the government gazette (*narodne novine*).

The Republic of Croatia issues guarantees to the HBOR, other banks, and selected enterprises. Its purpose is to guarantee the financial liabilities of economic entities that are majority-owned by the state. The government publishes data on guarantees issued in the official gazette broken down by type of entities (banks and other entities).

The debt management unit of the MOF is responsible for maintaining the official records of guarantees. Government guaranteed loans of central government units are netted out of the measure of public debt (debt plus guarantees) to avoid double counting. The guarantee records are maintained in a mixture of paper-based and electronic-based forms. The records are not complete – although MOF has been developing an improved guarantees register since the second half of 2003. When responsibility for guarantees was transferred to the debt management unit, not all the necessary records were transferred to it by other parts of the MOF or by line ministries. The official record of guarantees does not accord with the register of guarantees maintained in the CNB, which is compiled from information provided by commercial banks on government guarantees they are holding. There have been few attempts to reconcile the two sets of records and reconciliations have focused on external guarantees and external debt.⁴⁹⁵⁰ Guarantees are subject to audit by the SAO.

Reporting on guarantees is contained in the MOF Annual Report, the latest publicly available report being for 2001. The report contains data on guarantees issued for the previous six years, and the cumulative totals of new guarantees issued (but no information on calls or guarantees that have lapsed). There is also a breakdown by category (financial guarantees by domestic and foreign creditors, and performance guarantees), and by main sector. The Budget Act of 2003 requires a semiannual report to parliament on guarantees called.

Croatia's accounting standards require memorandum reporting of guarantees in the annual financial statements. The standards also require any guarantees judged at the reporting date as likely to be called to be recognized as liabilities, rather than treated as contingent liabilities. Because the official records of guarantees are deficient, no memorandum reporting or assessment of the likelihood of calls has taken place to date.

⁴⁹ Reconciliations are not performed on a regular basis; they are undertaken when major differences are detected to review the causes of the differences.

⁵⁰ Croatia's Stand-by Arrangement (SBA) with the IMF calls for, as a structural benchmark, the completion of the guarantee register (to include also local government guarantees) and the reconciliation of such data with the CNB data by end-December 2004.

42. **The main “fiscal balance” measure used to describe budget policy is the general government deficit, while the parliamentary appropriation is based on the overall (cash) balance of the consolidated central government.** In the *Explanation of the Budget* for 2004 the government described its budgeted fiscal performance in terms of the general government deficit. The budget proposal presented for approval, however, shows the overall balance of the consolidated central government (on a *GFS 1986* basis). There is no explanation of how the general government balance referred to in the *Explanation of the Budget* is derived from the consolidated central government balance that parliament actually appropriates. The Budget Act of 2003 contains some fiscal rules, including that the government debt to GDP ratio may not exceed 60 percent; that the proceeds from sales of shares and capital investment can only be used for the repayment of debt; and that the debt servicing payments of local self-governments may not exceed 20 percent of their previous year’s revenues. Performance against these fiscal rules has not yet been reported to the Sabor.

43. **There is no presentation of the public sector balance, despite the extensive quasi-fiscal activities of public enterprises.**⁵¹ A full understanding of the fiscal performance of the government in Croatia requires an assessment of those enterprises undertaking significant quasi-fiscal activities. There is no presentation of the balance of the non-financial public sector as a supplementary fiscal indicator. Nor is there a supplementary fiscal indicator that incorporates the quasi-fiscal activities of public financial institutions such as the HBOR.⁵² There is also no presentation of the aggregate financial performance of the enterprise sector, to enable an assessment of the government’s performance as steward of state assets.

⁵¹ Croatia’s Stand-by Arrangement (SBA) with the IMF limits the deficit of HBOR and the net borrowing by selected public enterprises.

⁵² According to the MOF, the HBOR receives payments from the Republic of Croatia only for overdue receivables related to loans guaranteed by the state. As HBOR’s expenses are financed by its own income, which is a normal banking procedure consistent with the laws on banks. In addition, the HBOR makes provisions for possible loan losses out of its own income on a regular basis, as shown in its audited financial statements. Possible loan losses are identified by the HBOR on a monthly basis in accordance to procedures as set by regulations of the Croatian National Bank. According to the HBOR, its financial statements are prepared in accordance with the International Financial Reporting Standards for banks as published by the International Accounting Standards Board. The HBOR’s financial statements include an overview of loan receivables broken down by purpose according to loan programs (under “Loans to Banks” (Note 5) and “Loans to other Customers” (Note 6)) According to the HBOR, it has not incurred any losses thus far and its overdue receivables have been collected within a given period. Total overdue receivables represent only 2.9 percent of all loans and are mostly two days overdue. In addition, the HBOR’s annual report includes data on the HBOR’s contingent liabilities (Note 25). Possible loan losses are covered by the HBOR out of its own income. The HBOR does not make loss provisions for loans guaranteed by the Government of the Republic of Croatia. Provisions for such losses are made in the State Budget for each year, on the basis of data the HBOR submits to the MOF for the purpose of drafting the State Budget.

44. There is no information presented with the budget on objectives or performance measures for expenditure programs. In 2002 line ministries started to develop program budgets. The Budget Guidelines issued for the 2004 budget instructed budget users to provide a description of each program, the legal basis for its implementation, necessary resource and manpower requirements, and an assessment of results. The Budget Act of 2003 requires that all these details be presented to the Sabor with the government's budget proposal.⁵³ Some line ministries provided this information to the MOF with their 2004 budget proposals. However, the MOF was not in a position to collate this information and present it with the budget. The intention is to start to do so in the 2005 budget. During budget execution, costs are not fully allocated to programs. There have also been changes to the program coding structure promulgated by the MOF, so that it is not possible to compare program spending between different years.

Clarity of budget execution

45. Cash is generally available to budget users when they need it during the year, although expenditure arrears still occur. A new State Treasury Department was established within the MOF in 2001 with a single treasury account at the CNB. This has resulted in stronger management and control of central government budgetary resources.⁵⁴ The consolidation of a number of extrabudgetary funds since 2001 means that a large proportion of central government expenditure now goes through the TSA—although the HAC, HC, the Croatian Water and Environmental Protection Fund, DAB, and HFP remain outside the TSA. Accounts payable and bills due for payment are recorded by departments in the commitments registration system of the Treasury's financial management information system (FMIS).⁵⁵ In principle, the MOF can monitor the outstanding obligations of budget users and the system should reject the entry of any commitment that would result in the budget user exceeding its cash limit for the month or its budget for the year. However, departments do not always enter obligations into the Treasury's FMIS, in part because they cannot reserve funds with the Treasury more than a month in advance. Efforts are currently being made to develop an interface between the Treasury FMIS and the various accounting systems used by budget users, which would improve the MOF's ability to monitor commitments. The Treasury is also considering extending the period for which departments can reserve funds.

46. Expenditure arrears also occur due to the difficulty in controlling expenditure on entitlements mandated by legislation. A number of laws mandate entitlement for citizens to receive services or payments (such as pensions or medical treatment). This

⁵³ The Act also requires that the semiannual and annual statements on budget execution shall include an explanation of program implementation.

⁵⁴ Spending units still have their own accounts in the state Postal Bank that they use for small cash payments.

⁵⁵ The Treasury uses a SAP system.

means it may not be possible for budget managers to stay within budget with respect to some expenditures, in the face of an unexpected increase in demand. Failure to seek authority for a reallocation or budget increase has at times resulted in expenditure arrears. They have been a particular problem in the health sector. The Health Insurance Fund has borrowed from a commercial bank, with a government guarantee, to clear the arrears.

47. The accounting system is capable of producing reasonably reliable in-year fiscal reports on the general government budget outturn. Up until 2001, the chart of accounts in use in Croatia did not clearly separate organizational, economic, and functional classifications. In addition, its scope was limited to consolidated central government. A new chart of accounts was introduced in 2002 that enables the generation of fiscal reports that are consistent with the *2001 GFSM*.⁵⁶ All general government entities are required to use the new chart of accounts as the basis for budgeting, accounting, and reporting.⁵⁷ This enables the generation of fiscal reports on the general government on a *2001 GFSM* basis. Foreign concessional loans are captured in the accounting system, but grant aid is not. Aid-in-kind is valued and recorded on the balance sheet of the recipient unit. Data on the central government accounts payable and on overdue payments (arrears) are produced by the MOF on a monthly basis, but they have not been published. The MOF has initiated work to assess the accuracy of arrears reporting. The chart of accounts has allowance for full balance sheets, containing both financial and non-financial assets. Line ministries are submitting financial statements to the MOF, but no consolidated financial statements have yet been published.

Control of budget execution

48. Procurement remains a problem area. The SAO has reported numerous instances of failure to observe legal requirements in its audits of state bodies in recent years. A new Public Procurement Act of 2001 provides for open, competitive, and decentralized procurement of goods and services by budgetary institutions. However, there was a considerable delay before the new Public Procurement Office (PPO) created by the Act was established in November 2003. The PPO has taken over the functions of the former Public Procurement Department of the MOF. The Act also established a new State Commission for the Supervision of Public Procurement, but the commissioners were not appointed until October 2003. The Procurement Commission is an independent body that oversees procurement and considers appeals against procurement decisions. It also has an educative role, and is compiling a publicly-available register of its decisions.

49. There are deficiencies in the Public Procurement Act, and the necessary implementing regulations are not all yet in place. There are many exceptions listed in the Act to the required procurement procedures. The Act is also not comprehensive—for

⁵⁶ Croatia is now reporting fiscal statistics to the IMF on the basis of *GFSM 2001*.

⁵⁷ The exceptions are that the HC, HAC, HFP, and DAB use commercial or non-profit accounting systems. Special forms are currently used to collect data from these entities for general government reporting.

instance, it does not cover electronic procurement. There is inadequate provision for parties who are prevented from participating in a tender due to illegalities to challenge the tender. The regulations required to properly implement the Act have not yet all been issued by the PPO, which makes it harder for budget users to comply with the law. In practice, government agencies frequently resort to sole source contracts rather than tendering. These issues are currently being considered by the government in a review of the Act.

50. The Civil Service Law contains a requirement to advertise vacancies, but is in need of strengthening in some areas. The Central State Office for Administration, a body under the jurisdiction of the prime minister, is responsible for regulating the terms and conditions of public servants. The Law on Civil Servants and Public Employees of 2002 requires advertising of vacancies (effected through publication in the government gazette), and provides for appeals against appointments. The law, however, does not provide for appointment on merit. It also does not distinguish between politically-appointed and career civil servants. Rulebooks on employment within individual government agencies are not entirely consistent with the law, creating the possibility of variation in civil service management standards.

51. Internal control is being strengthened, but there is at present no effectively functioning system of internal audit. At present there are a number of entities responsible for internal inspection functions within government ministries, including the Government Office for Internal Supervision reporting to the prime minister; the MOF's Directorate for Internal Audit and Control, the Budgetary Supervision Department, and the Office for Internal Supervision; and the Office for State Property. In practice the existence of multiple layers of checking within budget institutions, together with emerging and overlapping roles of different internal control bodies, acts to dilute responsibility and accountability. The SAO has consistently stressed the need for stronger internal control, and for better coordination among the different organizations exercising internal control functions. The Budget Act of 2003 initiated the establishment of an internal audit function within each budget user, and makes the head of each budget user responsible for financial propriety in their agency. The MOF is responsible for implementation and has completed a Book of Rules and an operating manual on internal audit.⁵⁸ Staff are being trained within the Directorate for Internal Audit and Control in the MOF, and will be transferred to the internal audit units as they are established. Decisions are still required on the relative roles of the Directorate for Internal Audit and Control, the internal auditors, and the various entities with internal inspection responsibilities.

52. Tax and customs administration is being strengthened, but there is at present no functioning internal audit capability in either area. The introduction of the VAT in 1998 is considered to have resulted in a sizeable reduction in the overall level of tax

⁵⁸ According to the MOF, the Book of Rules was published in National Gazette No. 111 of August 12, 2004. The policy paper on public internal financial control in Croatia was ratified by the government on September 2, 2004.

evasion in Croatia.⁵⁹ There is a need, however, to strengthen taxpayer inspection and to reduce the long delays in prosecution of those evading tax. The Tax Administration produces a range of explanatory materials for the taxpaying public. The Customs Administration provides advisory services, and conducts training for shipping forwarding agents to complete export and import declarations for exporters and importers. Tariff schedules are available to the public via the internet, and internet filing of documents has also been introduced. This simplifies procedures and reduces the opportunities for irregularities. There is a need to establish internal audit functions in the Tax and Customs Administrations, and staff training is being undertaken. The responsibility for excise tax collection was transferred from the Tax Administration Central Office to the Customs Administration in 2002, in line with the allocation of responsibilities in many European countries, but the function has not yet been adequately resourced within the Customs Administration.⁶⁰

Independence of the tax authorities

53. **The tax authority does not have specific legislative independence.** There is no legislation specifically protecting the head of the Tax and Customs Administrations from political interference in establishing the tax liabilities of individual taxpayers. In practice, however, political involvement in the determination of tax obligations has not been an issue. The Tax Administration does not issue annual reports; the *Annual Report* of the ministry of finance, however, covers changes in tax policy.

Reporting and review within year, and submission of final accounts

54. **Detailed monthly statistics are usually published on the budget outturn, although publication was intermittent throughout 2003.** The MOF publishes summary monthly budget outturn statistics in the *Statistical Review*, which is also available on MOF's website (www.minfin.hr/stat). The statistics include central government revenues by type, central government expenditures by economic type, the overall deficit, the current deficit, and the primary deficit, and budget financing by the type of debt holder. Comparative data are presented for previous years, as well as the amended state budget amounts for the current year (but not the original budget amounts), and the ratio of the previous month's total to the same month in the previous year. The target is publication within a month after the end of the reference month, although publication has only recently resumed after a break since July 2002, and the current lag is about two months.

55. **There is a midyear report on the budget outturn to the legislature.** In recent years a midyear report on the execution of the state budget has been presented to the Sabor within two months after the end of the reference period. These reports provide

⁵⁹ See *Developments in the Croatian Tax System*, Institute of Public Finance Newsletter No. 14, December 2003, available on the Institute's web site at www.ijf.hr.

⁶⁰ The government has decided to re-establish the financial police to improve collections.

important information on budgetary outturns to the parliament and the public, but do not present a comparison with the same period in the previous year, or an assessment of what the six-month outturn implies for the final end of year outturn. The Budget Act of 2003 requires that this report be submitted by August 5 of each year.

56. The unaudited *State Budget Execution Report* has in recent years been presented to the Sabor within approximately eight months of the end of the fiscal year. The government must submit the statement to the Sabor by June 1. In practice, in recent years the unaudited *State Budget Execution Report* has been presented to the Sabor within approximately eight months after the end of the fiscal year. It is not, however, accompanied by an opinion or report of the SAO, both of which are submitted to the parliament a number of months later. To date, the *State Budget Execution Report* has only included a comparison of budget outcomes with the revised supplementary budget estimates for revenue and expenditure programs. For the 2003 report, it is proposed to show a comparison with the original budget for the first time. More generally the report lacks an assessment of the reasons for any variations between budget and outturn, focusing instead on macroeconomic issues. In addition to reporting on a cash basis against their budget, budget users are also now required to prepare financial statements on a modified accrual basis, including a balance sheet. The MOF is required to consolidate these, to prepare financial statements of the state budget, and to deliver these to the government together with the semiannual and annual budget execution reports. No modified accrual-based statements have as yet been presented to the Sabor or published.

D. Assurances of Integrity

Integrity of data processes

57. The revenue projections provide a sound basis for the budget, but there are frequent reallocations from the original expenditure provisions. In recent years the revenue forecasts have tended to be based on cautious macroeconomic assumptions and have been achieved. The final revenue performance in each of 2002 and 2003 was about 1 percent higher than the original budget. The expenditure provisions, however, have been subject to frequent revisions during the year. This is a reflection of the process through which they were planned. The MOF methodology projects total available expenditure as a residual and then negotiates with line ministries. Final decisions within a ceiling are largely left to the line ministries and their allocations across the fourth level of economic classification are completed in a compressed time frame and are often inappropriate. There is also a weakness in the management of entitlement expenditures as discussed in paragraph 46.

58. Statements of accounting policy are not included in the budget and final accounts documents. Neither the budget documents nor the financial statements in the *State Budget Execution Report* contain statements of the accounting basis or accounting policies. However, instructions on accounting policy were provided to budget users by

the MOF in 2002.⁶¹ Since the introduction of the new chart of accounts in 2002 the government has had the ability to present a full set of accounts. However, it has continued to produce a cash-based operating statement and has yet to produce a balance sheet. The provision of balance sheet information is a requirement of the Budget Act of 2003.

59. The processes of accounts reconciliation and fiscal reporting are not fully in place. At the aggregate level, there have been major discrepancies between the reported “above the line” operating performance and the financing information from the CNB records. There are also significant differences in the records of public debt kept by the MOF and by the CNB relating to the area of debt guarantees. Different sources are used for the compilation of the data on guarantees by the two agencies and there are few attempts to reconcile the differences (see also Box 3).⁶² There is also no reconciliation of the change in debt stock during the year in reports to the Sabor. On an ad hoc basis reconciliation is attempted between the information kept by the treasury and the financial reports received from budget users. One observation from this process is that the invoice-based reports from users often show different areas of expenditures to those in the treasury system.

Independent oversight

60. The SAO has operational independence and a broad mandate. The SAO is established as an independent body under the Sabor by the State Audit Act. The Act permits a full range of audit activities including performance audit. In practice, the SAO, in addition to the examination of propriety and regularity of spending, includes some elements of performance auditing in its audits.⁶³ The Act requires that the audit follow the International Organization of Supreme Audit Institutions (INTOSAI) Standards. The SAO activities are made available to the public through its annual report, and its findings are available through the internet (<http://www.revizija.hr>).

61. Strengthening of audit capacity is required. The scope of audit coverage in the State Audit Act is very broad. It covers not just units of the state, local and regional self-governing units, but all entities partly or wholly financed from the budget, public enterprises and companies that are majority-owned by government, and the CNB.⁶⁴ While the audit of state and local self governing units is to occur on an annual basis, the other

⁶¹ While the Budget Act of 2003 specifies that budget accounting should be based on the International Public Sector Accounting Standard (IPSASs), the Act also stipulates that the recognition principle should be modified accrual. This is not yet fully consistent with the IPSASs.

⁶² The MOF information comes from budget users while the CNB information is from commercial banks in Croatia.

⁶³ That is, the SAO assesses not only the financial compliance but also the efficiency and cost-effectiveness of programs and whether the objectives of the programs have been achieved.

⁶⁴ The audit of the CNB is now performed by a private sector audit firm.

audits are to occur consistent with an approved audit program that can involve rolling three-year audits. Entities subject to the Companies Act are subject to additional annual audits by independent private auditing firms. The capacity of the SAO to conduct specialized audits such as value-for-money audits is limited. The SAO does not have financial independence as its budget follows the same process as that of budget units that report to the executive branch. It is also subject to limitations on the salary it can pay to its staff, which limits its ability to retain experienced staff. The SAO has a staff of 276 with a central office and 20 regional offices. While this is considered adequate for current functions, it does not allow more in-depth work including the development of performance audit activity.

62. The legislature discusses external audit reports separate from the *State Budget Execution Report* and systematic review and follow-up are limited. Article 11(2) of the State Audit Act requires that the SAO audit the accounts within five months of the date they are required to be produced. Given that the deadline for accounts is January 31 of each year, the audit must be completed by the end of June of the same year. In practice, however, the audit statement has not been submitted until later in the year. The *State Budget Execution Report* is required to be considered by the Sabor in June of the year. Therefore, the Sabor considers and passes the *State Budget Execution Report* prior to receiving the SAO report on the contents. The SAO reports are examined by the Finance and Central Budget Committee of the Sabor. The Committee has a broad mandate but limited professional staff, and this inhibits its ability to provide detailed review. However, in a welcome development the Committee has started to receive technical support from external expert representatives who have observer status. These include the Zagreb Institute of Economics; and the Institute of Public Finance has also provided assistance. There is no systematic mechanism for following up on the findings of the audit, and it is common for the same faults to be identified in subsequent years.

63. The capacity of the macroeconomic function within the MOF is being developed and linkages with external forecasters are being established. The Bureau for Macroeconomic Analysis and Planning is in the early stages of a significant development of its macroeconomic capacity.⁶⁵ In order to improve the information base for its forecasts, the Bureau is developing linkages with external institutes and forecasting units in the commercial banks. At present, there is limited interaction with the CNB during the forecasting process. The CNB has considerably greater forecasting capacity; however, it notes that because it does not receive adequate information from the MOF (in particular, that on debt amortizations and financing needs over the medium term), it only produces forecasts for the year ahead and these are of limited use for the MOF in producing medium-term forecasts. The MOF forecasts are not subjected to external review prior to their presentation to the Sabor. The forecasts are prepared in April as part of the initial stage of the budget preparation process and are not systematically updated prior to release in the budget in November.

⁶⁵ The Bureau has a new manager but the Bureau has yet to be fully staffed.

64. **The CBS is given legislative assurance of independence through Articles 8 and 11 of the Law on Official Statistics.** The CBS is responsible for compiling annual fiscal statistics based on a comprehensive statistical survey of all units constituting the general government. The CBS also produces quarterly fiscal statistics based on information provided by the MOF on state budget activities and, on its own statistical estimation of local government activity. These statistics are published three months after the end of the quarter. As indicated in paragraph 26, the CBS is working with the MOF and the CNB to standardize the coverage of the general government in fiscal reporting.

III. IMF STAFF COMMENTARY

65. Croatia currently meets the requirements of the fiscal transparency code in the following areas:

- The allocation of responsibilities among different levels of government has generally been well defined; intergovernmental fiscal relations have been established, with tax assignments clearly set by laws and regulations, although decentralization to date has not taken sufficient account of the limited fiscal capacity of the smaller subnational units.
- The Croatian National Bank has both legal and operational independence from the government in the conduct of monetary policy.
- The accounting system is based on a new chart of accounts introduced in 2002 that enables the generation of fiscal statistics covering the general government in conformance with the IMF's *Government Finance Statistics Manual 2001*. Budget data are mainly presented on a gross basis,⁶⁶ as called for in the *Transparency Code*.
- Within-year fiscal reporting in recent years has generally exceeded the requirement in the Code, which calls for quarterly reporting within a quarter of the end of the reference period. Within-year fiscal reports, both in Croatian and in English, are disseminated by the ministry of finance on its website.
- Consolidated accounts of the central government are presented to the parliament within a year after the end of the reference fiscal year.
- The State Audit Office has a broad mandate covering all general government units and all publicly-owned entities and it reports directly to the parliament on the results of its compliance auditing.

⁶⁶ The exceptions are that the HC, HAC, HFP, and DAB use commercial or non-profit accounting systems. Special forms are currently used to collect data from these entities for general government reporting.

- The Croatian Bureau of Statistics Act provides the agency with technical independence in the production of official statistics; there is, however, a need for better coordination among the CBS, the MOF, and the CNB so that fiscal statistics that they compile are consistent one with another.

66. In addition, Croatia has made significant progress in enhancing fiscal transparency in a number of respects in recent years, including the following:

- The 2004 budget presented to the parliament contained a more detailed *Explanation of the Budget* than in previous years, including macroeconomic assumptions on which the budget forecasts were based.
- The capacity of the macroeconomic function within the MOF is being strengthened and linkages with external forecasters are being developed. The MOF commissioned in 2004 an external quantitative analysis of public debt sustainability, which has been published. Documents on Croatia's Standby Arrangements with the IMF have also been publicly available in recent years.
- A modified accrual accounting basis has been adopted, and line ministries are now submitting to the MOF regular monthly information on their liabilities, including expenditure arrears. The MOF has initiated work to assess the accuracy of arrears reporting. Line ministries have physical asset registers, and some physical assets are valued. However, no total figure for expenditure arrears has been published, and no consolidated balance sheet of government has been produced.
- The establishment of a treasury single account in 2001 and subsequent expansion of its coverage has improved both the control over budget execution and the availability of cash allotments to line ministries to implement their approved budgets. However, the own revenues of some budget users are off-budget and do not flow through the TSA; and the HAC, HC, DAB, and HFP have not been incorporated in the TSA. In addition, the commitment registration system is not yet fully functional.
- Steps have been taken to improve the transparency of the bidding and selection process for privatizations.
- Legislation and administration in the areas of value added tax (VAT) and customs duties are being aligned with EU practices.
- The regulation of the financial sector has been strengthened; and the regulation of the nonfinancial private sector is being aligned with EU practices.
- Some measures to combat corruption have been taken, including the establishment of an anti-corruption agency.

67. Nonetheless, the following fundamental weaknesses in fiscal management and transparency exist:

- **Weak compliance with and ineffective enforcement of laws and regulations on public financial management, compromising overall fiscal oversight and control.** This weakness exists at the general budget management level (many requirements of the Budget Act of 2003 have yet to be implemented), in institutions in all branches of the Republic, with respect to budgetary control and oversight (unclear oversight responsibilities shared among multiple agencies), and in specific government operations and activities (including the issuance of guarantees and the enforcement of public procurement procedures).
- **Extensive fiscal and quasi-fiscal activities undertaken outside the budgetary process, undermining the sound management of fiscal risks.** The cumulative effect of these activities (including the use of guarantees, the assumption of public enterprise debt by the government, quasi-fiscal activities by public enterprises, special tax exceptions, and off-budget own revenues of selected budget users) has diminished the ability of the parliament to exercise oversight and the executive branch to control fiscal policy formulation and execution. The fiscal risks embedded in these activities are not systematically assessed by the government and not publicly disclosed.⁶⁷
- **Inadequate coordination and limited information-sharing among government agencies** responsible for fiscal policy and fiscal management, and even among different units within the same agency. In combination with weak compliance with and weak enforcement of public financial rules and regulations and extensive off-budget fiscal activities, this further hampers fiscal accountability.

To address these major issues of fiscal management and transparency, and in response to the authorities' request that this ROSC mission provide Croatia a road map for further fiscal reforms, the IMF staff recommends the authorities take actions in several priority areas in the near and medium term.

Because of their important implications for fiscal management, improvements are urgently needed in the following areas:

(A) **The government better manages and exercises accountability over government guarantees and the assumption of debt.** The extensive use of government guarantees is undermining fiscal management. In effect, the granting of guarantees functions as a parallel budget system. There is inadequate information on guarantees provided to the parliament with the annual budget, inadequate scrutiny of new guarantee proposals, and serious deficiencies in record keeping and reporting of the guarantees. Yet,

⁶⁷ See also footnote 48.

such guarantees pose considerable fiscal risks. There is also a lack of transparency with respect to the assumption of debt by the government.

Recommendations

- The guarantees register in MOF should be computerized, reconciled rigorously against CNB records and other sources of information; and an explanatory report on the reconciliation should be presented to the parliament with the 2004 midyear budget execution report. (Near term.)
- When new guarantees granted are published in the monthly gazette, the amount of the gross exposure under each guarantee should also be published. Once guarantees are exercised, they should be properly included in the fiscal accounts. In addition, all calls on guarantees should be properly recorded in the accounting system. (Near term.)
- Starting with the 2005 budget proposal, the parliament should be presented with a separate “Guarantees Budget Statement,” with details for the previous three years on the stock of active guarantees, past calls, total debt assumed by the government, total claims on original debtors and claims waived, any reserves established (e.g., reserves of the DAB), an explanation of the amounts charged against the “Guarantees Fund” and the amount allowed for in 2005, and the average interest rate on guarantees. (Near term.)
- When the government assumes debt it should report immediately to the parliament on the rationale for the measure and its fiscal impact. The end of year financial statements should incorporate and disclose the debt assumptions that have taken place. (Near term.)
- Commencing with implementation of the 2005 budget, there should be a quarterly report to the parliament with full details of all new guarantees issued and new calls made, collateral obtained, claims established, and claims waived. All new guarantee proposals should first be assessed by the Budget Preparation Department with respect to general government entities, and by the Economic Department of the MOF with respect to public enterprises.⁶⁸ (Near term.)
- The government should publish an annual reconciliation of the change in the government debt, explaining the reasons for the change in debt between the beginning and end of the year, and apportioning the amount of the change among the fiscal deficit, assumption of debt, and other reasons. (Medium term.)

(B) The MOF gives priority to the strengthening of debt management. The government currently does not have a comprehensive debt strategy and provides limited

⁶⁸ However, monitoring could be undertaken by one unit.

information to the Sabor on debt management. The function is divided among a number of departments within the MOF, the principal department has limited staff and information technology capacity, and there are inadequate internal controls.

Recommendations

- Comprehensive debt management objectives and operational guidelines that link current operations to the objectives should be developed and presented to the Sabor, in the context of the overall fiscal strategy discussed in (E) below. (Near term.)
- The various debt management functions should be consolidated within the Debt Management Department in the MOF. (Near term.)
- Front, middle, and back office functions of the DMD should be separated and capacity should be developed. (Near term.)
- An information technology system that links the DMD to the treasury financial management information system should be developed. (Medium term.)

(C) The MOF enhances the functionality of the treasury system and the parliament appropriates expenditures that are currently financed from certain budget users' own revenues. There are limitations to the operation of the treasury system that inhibit the effective management and control of cash, leading to arrears. There are also gaps in the coverage of the budget such that certain public funds are not appropriated by the Sabor and are sometimes not reported.

Recommendations

- The timeframe over which reservations can be entered into the treasury system should be expanded beyond one month in order to make the commitment registration system function effectively. (Near term.)
- All expenditures currently financed from own revenues of selected budget users should be appropriated in the budget. (Near term.)
- All current extrabudgetary funds (health, pension, employment, and the new environmental fund) should be brought onto the budget and budget documents should include an overall presentation of the revenues and expenditures of each fund. In addition, the TSA should cover all agencies including the HAC, HC, HFP, and the DAB.⁶⁹ (Near term.)

⁶⁹ Among the structural benchmarks in the SBA are that the DAB be included in the TSA by end-June 2005; HFP, by end-September 2005; and HAC and HC, by end-December 2005.

- All unauthorized bank accounts of budget users should be closed, and authorized accounts should be operated on a zero balance basis. (Near term.)
- An electronic interface should be completed between the treasury and the accounting systems of budget users. (Medium term.)

(D) The government completes and disseminates regulations (books of rules) required by the Budget Act of 2003 and other laws to strengthen financial reporting, internal control, and procurement. The Budget Act of 2003 mandates that detailed regulations be put in place in a number of areas to implement the law. The Procurement Act has a similar requirement. Many of these “books of rules” have yet to be completed making it difficult for compliance with the Budget Act to be enforced.

Recommendations

- The MOF and the Public Procurement Office should actively disseminate and promote the procedures required in the new procurement regulations to ensure budget users understand and are able to comply with them. (Near term.)

Other key areas that require improvements in the near and medium term include:

(E) The MOF provides additional information to the parliament with the annual budget proposal. Currently, the annual budget documents contain no discussion of the government’s medium-term fiscal strategy and no medium-term macroeconomic and fiscal forecasts. It is not transparent what expenditure and revenue policy changes are being introduced in the annual budget. Nor is it clear how the different fiscal deficit measures relate to each other, or what performance is against the various fiscal rules in the Budget Act. There is also limited information on fiscal risks.

Recommendations

- Starting with the documentation presented to the parliament with the 2005 budget proposal, the *Explanation of the Budget* should present a three-year set of macroeconomic forecasts, a statement and discussion of the government’s medium-term fiscal strategy, some indication of the sensitivity of the budget to changes in macroeconomic parameters, and more information on guarantees (see (A) above); an explanation of how the various deficit measures relate to each other (including the primary deficit); an overview of the expenditure policy changes being introduced in the budget; and additional program information submitted to the MOF by line ministries with their budget proposals. (Near term.)
- This should be progressively augmented with: an enhanced medium-term fiscal forecast and longer-term fiscal sustainability analysis; a current services expenditure baseline (initially on an aggregate basis and subsequently at ministry and program level) and clear identification of all spending and revenue policy

changes being introduced in the budget and the fiscal impact of each decision; and a measure of the public sector deficit. (Medium term.)

- The Budget Preparation Department in the MOF should play a larger role in developing the expenditure baseline for the medium-term fiscal forecasts. (Medium term.)

(F1) The government strengthens internal control of fiscal operations. There is currently no functioning system of internal audit in budget users; and the responsibilities of financial oversight shared among multiple agencies are unclear; both aspects have hampered fiscal accountability.

Recommendations

- Develop clear institutional roles and responsibilities with respect to internal audit and internal inspection. (Near term.)
- Progressively establish internal audit units in budget users as suitable staff become available. (Near to medium term.)

(F2) The MOF enhances the transparency of tax and customs policy and administration. At present, it is not transparent what new revenue measures are being introduced in the annual budget. There is no information on the fiscal impact of the increasingly large number of exceptions in various tax laws. There are no annual reports⁷⁰ on the operational activities of the Tax Administration and the Customs Administration, no functioning internal audit units in the two agencies, and insufficient resources devoted to taxpayer inspection.

Recommendations

- For the 2005 budget, the *Explanation of the Budget* should contain a description of the government's medium-term revenue strategy (in the context of the overall medium-term fiscal strategy as noted in (E) above), a full list of all the new revenue measures being introduced in the budget together with the estimated fiscal effect of each measure, and a simple list of all tax expenditures in revenue statutes. (Near term.)
- Establish internal audit units, and strengthen taxpayer inspection. (Near term.)
- In successive budgets, the information on tax expenditures should be progressively expanded to include estimates of the fiscal impact of each tax expenditure and a justification for the expenditure. (Medium term.)

⁷⁰ The *Annual Report* of the Ministry of Finance only covers the changes in tax policy.

- The Tax Administration and the Customs Administration should each publish annual reports on their operations as supplements to the MOF's annual report for 2005, describing their revenue collection, taxpayer inspection, internal control, and other activities. (Medium term.)

(G) The parliament more actively oversees the budgetary process. The Sabor does not have a formal role in the budget process until the budget proposal is presented to it in mid-November. The Sabor has limited time and resources to assess adequately the content of the budget and to review effectively the government's fiscal strategy.

Recommendations

- A midyear budget strategy document that reflects the government's decisions on the budget guidelines (including macroeconomic forecasts, fiscal objectives, and policy priorities) should be developed. The *Budget Guidelines* for the 2005 budget should be publicly disseminated, and an opportunity should be provided for the Sabor to discuss them. (Near term.)
- The content of all the documents presented to the Sabor should be improved, as identified under (E) shown above on improving budget preparation. (Near term.)
- The resources of Sabor's Finance and Central Budget Committee should be increased and an opportunity should be provided to the Committee to discuss with the minister of finance the budget for the State Audit Office. (Medium term.)

(H) The government improves the oversight and the reporting on public enterprises. The oversight of Croatia's large public enterprise sector is scattered among a number of agencies. There is limited coordination of the oversight function and there is not a strategic focus to the specific fiscal and regulatory interventions relating to each enterprise. There is also no reporting to the Sabor on the aggregate performance of public enterprises.

Recommendations

- Expected performance standards should be set with respect to each subsidy to enterprises. (Near term.)
- There should be a systematic identification and reporting in the budget documents on quasi-fiscal activities performed by public enterprises. (Medium term.)
- The information on quasi-fiscal activities in budget documents should be progressively developed through inclusion of estimates of the costs of each quasi-fiscal activity. (Medium term.)
- Capacity to assess and report on the effectiveness of the overall mix of government interventions for a public enterprise (including guarantees, subsidies,

pricing policy, and specific regulations) should be developed within the MOF. (Medium term.)

- A coordinated system for reporting on the full range of state- and locally-owned enterprises and advising the relevant legislative body on management and dividends policy, including goals for privatization, should be developed. Specifically, a clear dividend policy should be developed, and any dividends paid should be made directly to the budget. Separately a specific appropriation should be established for the operating expenditure of the HFP. (Medium term.)
- A methodology for reporting on public enterprises and equity holdings, with a view to monitoring the government's overall balance sheet (including all public enterprises) should be developed. (Medium term.)

(I) The MOF, the Croatian National Bank, and the Croatian Bureau Statistics reconcile their fiscal data. There is inadequate reconciliation of fiscal data published by the MOF, the CNB, and the CBS.

Recommendations

- The MOF takes immediate steps, in conjunction with the CNB, to reconcile discrepancies in the data on the fiscal deficit, government debt, and government guarantees. Present in the 2005 *Explanation of the Budget* an assessment of the results of these reconciliations. (Near term.)

(J) The government strengthens coordination among its agencies in their financial oversight. There are a range of areas where different government agencies involved in financial oversight are not coordinated or their respective roles are not clear. This is affecting accountability and data quality.

Recommendations

- The roles and responsibilities for the management of guarantees should be resolved. (Near term.)
- Mechanisms for coordinating the responsibility for oversight of public enterprises should be established. (Medium term.)
- Clear institutional roles and responsibilities with respect to internal audit should be decided. (Medium term.)

(K) The MOF strengthens the Budget Act of 2003 as the opportunity arises. The Budget Act of 2003 was a major improvement; it provides the legal basis for more transparency and accountability. However, the Act currently does not address some transparency and budget management issues.

Recommendations

- The Act should more clearly specify the content and timing of executive reporting obligations to the parliament, particularly the expanded content of the *Explanation of the Budget* as discussed under (G) shown above. (Medium term.)
- There is a need to simplify the Act by transferring some details to implementing regulations. (Medium term.)
- There are also a number of inconsistencies in the accounting elements of the Act that should be rectified. (Medium term.)

A Summary Assessment of Practices

Overall summary

Croatia meets the fiscal transparency code in a number of areas and has been making significant progress in strengthening fiscal management and transparency. The allocation of responsibilities among different levels of government has generally been well defined and stable intergovernmental fiscal relations have been established; the Budget Act of 2003 has significantly strengthened the legal framework for budget management; the establishment of a single treasury account (TSA) has improved controls over budget execution; the new chart of accounts introduced in 2002 has facilitated the production of fiscal statistics on the general government in conformance with international standards; and legal frameworks for taxation, regulation, and administrative procedures are being harmonized with EU standards, in conjunction with Croatia's application for EU accession.

Nonetheless, major weaknesses remain. These include weak enforcement of laws and regulations on public financial management, compromising fiscal oversight and control; extensive fiscal and quasi-fiscal activities undertaken outside the budgetary process, undermining the sound management of fiscal risks; and inadequate coordination among government agencies responsible for fiscal management, hampering fiscal accountability. Because of their important implications for fiscal management, improvements in the following areas are urgently needed: the government better manages and exercises accountability over government guarantees and debt assumptions; the Ministry of Finance (MOF) gives priority to strengthening debt management; the MOF incorporates in the TSA government agencies HAC, HC, DAB, and HFP and makes the commitment registration system function effectively; the MOF provides, with the annual budget proposal to the parliament, additional information on medium-term macroeconomic and fiscal forecasts and fiscal strategy, the policy basis of the budget, and more detailed analysis of fiscal risks; and the parliament appropriates expenditures currently financed from certain budget users' own revenues; and the government completes and disseminates regulations (books of rules) required by the Budget Act of 2003 and other laws to strengthen financial reporting, internal control, and procurement. the government strengthens internal control of fiscal operations.

Other key areas for reforms in the near term include: the government strengthens internal control of fiscal operations and the MOF enhances the transparency of tax and customs policy and administration; the parliament more actively oversees the budgetary process; the government improves the oversight and the reporting on public enterprises; the MOF, the Croatian National Bank, and the Croatian Bureau Statistics reconcile their fiscal data; and the government strengthens coordination among its agencies in their financial oversight responsibilities.

Code Reference	Summary Assessments	Comment
Clarity of roles and responsibilities		
1.1.1	The government reports on operations of the general government sector, but the coverage of the sector needs to be consistent among key reporting agencies.	Resolving the different coverage of general government among MOF, CNB and CBS should be a near term priority.
1.1.2	The fiscal roles of the executive, legislative, and judicial branches are defined in the constitution and in the Budget Act of 2003.	Improved with the Budget Act 2003, address some weaknesses in the Act as opportunity arises.
1.1.2	The role of the subnational government is clearly defined.	
1.1.2	The laws and regulations defining the responsibilities of different levels of government provide a stable basis for intergovernmental fiscal relations.	
1.1.2	The tax-sharing criteria are clearly established by law.	
1.1.2	The Budget Act of 2003 also applies to subnational governments and the budget classification is standard for all levels of government.	
2.1.5	Subnational government units are allowed to borrow either domestically or abroad with the approval of the MOF.	
1.1.2	The Budget Act of 2003 provides a much-improved framework for the management of budget funds, but there are areas where it could be strengthened.	
1.1.3	Debt management functions have not been formally organized.	
1.1.3	Improvements have been made to the coverage of extrabudgetary activities.	
1.1.4	There are no clear regulations for profit transfers from public enterprises to the state budget.	
1.1.4	The CNB has operational independence, and its financial relationship with the government is transparent.	

1.1.4	Public financial institutions perform explicit quasi-fiscal activities, and the fiscal activities performed through the Croatian Development and Reconstruction Bank (HBOR) have been more clearly reported by the government since 2004.	Fiscal reporting should include the significant quasi-fiscal activity of the HBOR.
1.1.4	Public enterprises carry out significant quasi-fiscal activities.	Fiscal reporting should include enterprises with significant quasi-fiscal activity.
1.1.5 & 2.1.4	There is a lack of clarity in the oversight responsibility on the government's holdings of fully-owned corporations and equity.	A medium-term priority should be to establish clear responsibilities and a coordinated system of reporting on public enterprises.
1.1.5	The procedures for privatization activity are well defined, and steps have been taken to improve the transparency of the bidding and selection process.	Improvement in recent years.
1.1.5	The clarity of the government regulation of the private sector has been improved in some important areas.	Significant improvement in financial regulation.
1.2.1	The steps in the annual budget process are set out in the Budget Act of 2003, but provide for limited involvement of the Sabor.	Some recent improvements, but need to progressively expand the range of information presented to parliament with the annual budget, and strengthen parliamentary oversight.
1.2.2	VAT and customs tax policies are increasingly being harmonized with EU standards, but there is a large and increasing number of exceptions in tax statutes, diminishing transparency and certainty.	Some recent improvement, but need to report tax expenditures and strengthen tax and customs administration.
1.2.2	The MOF has primary responsibility for tax and customs policy.	
1.2.2	Tax and customs administration is being strengthened, but there is at present no functioning internal audit capability in either area.	
3.3.4		
1.2.3	Civil servants are subject to standards of conduct.	Align Civil Service Law with EU standards.
1.2.3	Some measures to combat corruption have been taken but more progress is required in this area.	Continuing attention required.

Public Availability of Information		
2.1.1	Budget documents cover nearly all of the consolidated central government fiscal activities.	
2.1.1	Fiscal reports are available both for the consolidated central government (CCG) and a significant part of the general government (GG).	
2.1.5	The annual budget documents contain no information on fiscal outturns of previous years or forecasts beyond the budget year.	
2.1.2	There is no information in the budget on existing contingent liabilities but they are partially covered in the MOF's monthly <i>Statistical Review</i> and annual report.	
2.1.3	There is no reporting on tax expenditures and quasi-fiscal activities.	
2.1.3	Quasi-fiscal activities are not reported either in fiscal documents or other documents of the central government, or in the annual reports of public enterprises.	
2.1.3	There is a lack of transparency with respect to the use of guarantees.	Need to publish reliable information on stock of guarantees, and present a "Guarantees Budget Statement" alongside annual budget.
2.1.4	There is also a lack of transparency with respect to the assumption of debt by the government.	Need to disclose debt assumption and reconcile change in debt stock.
2.1.4	Central government reports regularly and on a timely manner on its gross debt level and composition.	
2.1.4	There is no reporting on government financial assets.	
2.1.5	Local governments report quarterly to the MOF.	
2.2.1	The Budget Act of 2003 requires that the annual statement of budget accounts be prepared by the state and local governments, including extrabudgetary funds (EBFs), and sent to the SAO and to the parliament.	

2.2.2	A six-month advance calendar is provided in the MOF monthly <i>Statistical Review</i> .	
Open Budget Preparation, Execution, and Reporting		
3.1.1	The fiscal forecasts presented with recent budgets were for the budget year only, and there was limited discussion of medium-term fiscal policy objectives.	
3.1.3	The macroeconomic forecasts are prepared increasingly with the use of a consistent framework and a range of sectoral and macroeconomic data.	
3.1.4	It is difficult to determine from the budget presented to the Sabor what new revenue and expenditure policies are being proposed.	Need to list all new revenue and expenditure policies being introduced in budget.
3.1.5	Beyond an allowance for unexpected spending and calls on guarantees, there is no information presented with the budget on fiscal risks.	Need to present sensitivity of budget to macroeconomic assumptions.
3.2.1	Budget data are presented mainly on a gross basis, and classifications conform to international standards.	Much improved chart of accounts in 2002, need to disclose remaining own revenues.
3.2.2 3.4.3	There is no information presented with the budget on objectives or performance measures for expenditure programs.	Line ministries are developing program details. Progressively include in annual budget.
3.2.3	The main “fiscal balance” measure used to describe budget policy is the general government deficit, while the parliamentary appropriation is based on the overall (cash) balance of the consolidated central government.	Need to present supplementary fiscal balance indicators, and show each derived.
3.2.4	There is no presentation of the public sector balance, despite the extensive quasi-fiscal activities of public enterprises.	

3.3.1	Cash is generally available to budget users when they need it during the year, although expenditure arrears still occur.	Establishment of TSA in 2001 improved reliability of budget execution. Need to expand coverage of TSA, make commitments registration fully effective, and improve oversight of entitlement spending. Publish accounts payable and arrears.
3.3.1	Expenditure arrears also occur due to the difficulty in controlling expenditure on entitlements mandated by legislation.	
3.3.1	The accounting system is capable of producing reasonably reliable in-year fiscal reports on the general government budget outturn.	
3.3.2	Procurement remains a problem area.	2001 law an improvement, but needs to be amended and implemented effectively.
3.3.2	There are deficiencies in the Public Procurement Act, and the necessary implementing regulations are not all yet in place.	Some improvement in transparency required.
3.3.2	The Civil Service Law contains a requirement to advertise vacancies, but is in need of strengthening in some areas.	Progressively establish internal audit units. Decide roles of different central units.
3.3.3	Internal control is being strengthened, but there is at present no effectively functioning system of internal audit.	Resume regular monthly publication.
3.4.1	Detailed monthly statistics are usually published on the budget outturn, although publication was intermittent throughout 2003.	Report is timely but need to include additional information.
3.4.1	There is a midyear report on the budget outturn to the legislature.	Parliament should not adopt the Report until it has SAO report.
3.4.2	The unaudited <i>State Budget Execution Report</i> has in recent years been presented to the Sabor within approximately eight months of the end of the fiscal year.	
Assurances of Integrity		
4.1.1	The revenue projections provide a sound basis for the budget, but there are frequent reallocations from the original expenditure provisions.	Develop budget process to increase attention given to expenditure provisions in the budget.
4.1.2	Statements of accounting policy are not included in the budget and final accounts documents.	Significant improvement with new chart of accounts. Start to publish full suite of financial statements.

4.1.3	The processes of accounts reconciliation and fiscal reporting are not fully in place.	Address differences in debt and guarantee records.
4.2.1	The SAO has operational independence and a broad mandate.	Look to develop additional financial independence.
4.2.1	Strengthening of audit capacity is required.	Amend State Audit Act and Budget Act of 2003 to require that the budget execution report submitted to Sabor include a statement on the report from the SAO.
4.2.1	The legislature discusses external audit reports separate from the <i>State Budget Execution Report</i> and systematic review and follow-up are limited.	Build on recent progress.
4.2.2	The capacity of the macroeconomic function within the MOF is being rebuilt and linkages with external forecasters are being developed.	
4.2.3	The CBS is given legislative assurance of independence through Articles 8 and 11 of the Law on Official Statistics.	