



Government of the Republic of Croatia

Strategy for the Development and Modernization of the State Treasury

2007 – 2011

August 2007

Government of the Republic of Croatia

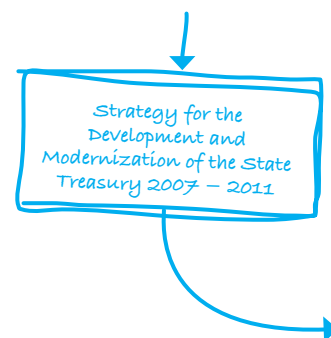
Strategy for the Development and Modernization of the State Treasury

2007 – 2011



table of contents

8	FOREWORD
12	1. INTRODUCTION
17	2. GOALS OF THE STRATEGY FOR THE DEVELOPMENT AND MODERNIZATION OF THE STATE TREASURY
17	2.1. Definition and organization of the State Treasury of the Republic of Croatia
19	2.2. Goals of the Strategy
22	3. MODERNIZATION OF PROCESSES
22	3.1. Budget preparation
22	3.1.1. Preparation cycle
30	3.1.2. Budget classification/Budget structure
33	3.1.3. Programme budgeting
36	3.2. Budget execution
36	3.2.1. Budget execution process
45	3.2.2. In-year financial planning
50	3.3. Accounting and reporting
56	3.4. Development of Public Internal Financial Control (PIFC)
59	4. STATE TREASURY INFORMATION SYSTEM
64	5. LEGAL FRAMEWORK, ORGANIZATIONAL ISSUES AND CHANGE MANAGEMENT
72	6. CONCLUSION - PRIORITIES, TIME-FRAME AND FUNDING



Message from the Minister of Finance

It is with pleasure that I present to you this strategic document, which highlights the methods, activities and goals of our continuing efforts to improve and modernize budgetary processes and strengthen fiscal discipline in the Republic of Croatia.

Over the last four years, great strides and important arrangements have been made towards creating the necessary framework for quality development of public finances in Croatia. Some major reforms have been implemented, including the establishment of the Treasury Single Account, introduction of budgetary analysis and financial impact assessment of legislation on the State Budget, as well as the development of a public relations policy to effectively communicate budget information, objectives and results to the public. The results of these efforts can already be seen in a number of areas: management of revenues; clear and lawful budget execution process; expenditure financing compliance; accountable and efficient use of public resources; comprehensive information on the general government's fiscal position and financial trends; control over budgetary users' spending and efficient resource allocation; cheaper and faster operations and better decision-making.

Of course, our work is far from done and we will continue our efforts towards the implementation of progressive reforms to develop our public financial management system into a highly intelligent support system for strategic decision-making.

The Strategy presented here sets out a framework for the implementation of strategic planning and multi-year budgeting, modern methods of financial planning, cash and public debt management and greater flexibility in budget execution, with the emphasis on outcomes rather than expenditures.

The reforms and a detailed plan of measures for the upcoming period are evidence of the strong support that this Government has given to the development of the State Treasury as an instrument of fiscal discipline and one of the key mechanisms in the fight against corruption.



Strategy
for the
Development and
Modernization
of the
State Treasury
2007 - 2011

Foreword

Our goal is to make our activities open and transparent to the public, show how government revenues are spent and demonstrate, with hard data, that the primary focus of attention of the State and Government are their own citizens. To achieve this purpose, citizen's guides to the State Budget and budget execution were launched already in 2006 and 2007:

- in 2006, a citizen's guide for the 2007 budget was prepared, whereas

- in 2007, after the annual accounts for the 2006 budget had been settled, another guide was issued to show citizens, in a simplified manner, what was done in 2006 and how budget funds were spent.

We intend to pursue and develop such projects in the future. Nothing will be hidden from our citizens, media, civil society institutions, research organizations... because we know that productive development requires open communication with everyone, all the more so because we all share the same goal: sustainable, efficient and effective progress of the country.



A handwritten signature in blue ink, which appears to read 'Ivan Šuker'. The signature is stylized and cursive.

MINISTER OF FINANCE

Ivan Šuker

Foreword by the Chief State Treasurer

In practice, different definitions are often used to refer to the term “State Treasury”. It can thus be taken to mean a system whereby revenues are managed and allocated, the chief mechanism of public finance management or an information system for the efficient use of public resources and enforcement of financial discipline.

All the above definitions are correct and the practical organisation and functioning of any Treasury will generally depend on the commitment of the Government to manage public finances in a straightforward and quality manner and communicate all pertinent information openly to the public.

To achieve our goal of creating the enabling environment for continuous growth and development, we have developed this Strategy that sets out our objectives for public finance management and how they will be achieved in the period 2007 to 2011. The Strategy for the Development and Modernization of the State Treasury is geared towards building an efficient and sustainable system of financial management, based on modern instruments and mechanisms in line with European standards.

Given the role of the State Treasury in supporting the achievement of the key objectives of public financial management, such as:

1. proper use of public resources in accordance with legal and regulatory requirements,
2. transparency of the system (providing information for stakeholders in a format that facilitates understanding and further analysis), and
3. a working system of accountability,

the development and modernization of the State Treasury system remains to be the main focus of the work carried out by the Ministry of Finance.

Strategy
for the
Development and
Modernization
of the
State Treasury
2007 – 2011

Foreword

The significant efforts that have been made so far to improve the State Treasury system are beginning to deliver their first tangible results, such as: direct payment of invoices to suppliers to avoid the unnecessary transfer of funds to budget users' accounts and better management of available cash balances and investments.

The document presented here is designed to give you a good insight into the following key areas: definition and organization of the State Treasury in the Republic of Croatia; current practices and the state of development of budgetary processes (i.e. planning, execution, cash and public debt management, accounting); planned goals and modernization measures aimed at their achievement.

Continuous improvement of the Treasury function and implementation of modernization initiatives will bring new values and modify behaviour patterns to support a more accountable, transparent and performance-oriented public sector.



A handwritten signature in blue ink that reads "Orlandini".

CHIEF STATE TREASURER
Vesna Orlandini

1. Introduction

Croatia has made significant progress in the area of public finances over the past several years.

Since having been officially granted candidate status for European Union membership (hereinafter, EU), Croatia has continued the difficult work of preparing for its full membership, notably in aligning national legislation with the EU *acquis communautaire*.

The requirements of EU accession in relation to fiscal policy and budget management, which are expected of any country seeking full EU membership, primarily concern the implementation of legislation governing financial controls, management of fraud and irregularities, adjustment of fiscal policy objectives in line with the Maastricht Criteria and compatibility with statistical requirements.

Fiscal consolidation has become a central objective of fiscal policy. This resulted in a decrease in the general government deficit from 4.8% in 2004 to the level of 3.0% in 2006 and a still lower 2.6% of GDP in 2007, bringing the general government deficit within the limit set for the Euro zone countries. At the same time, the public debt declined from 49.1% of GDP in 2005 to 46.4% of GDP in 2006, only to decrease even further to 44.7% of GDP in 2007.

Since 2002, a new concept of budgetary accounting has been implemented. All general government entities now use a single Chart of Accounts based on the economic classification of public revenues and expenditure and a decimal system with five levels of detail. The changes that have been introduced in the Croatian budgetary system were primarily driven by the need to develop and align the national classification system with international standards and practices and ensure quality information on business operations of individual public entities and the government as a whole, as well as to adapt to global trends and harmonization requirements imposed by major macroeconomic statistical systems (change of the accounting principle).

Statistical reports prescribed by the European Commission with respect to public finances, government deficit and debt statistics, i.e. the general government's fiscal position, are based on the ESA 95 methodology (European System of Accounts)¹. The Croatian budget accounting system uses modified accrual-based accounting principles² but its records and reports are conceptually capable of providing full accrual information to meet the reporting

Strategy for
the Development
and
Modernization
of the State
Treasury
2007 - 2011

requirements of any statistical system, including that of the European Union.

As a candidate country, Croatia is required to submit general government deficit and debt reports to the European Commission once a year, no later than April 1. So far, the Croatian Ministry of Finance has prepared two such reports or Fiscal Notifications, as they are called. The report from 1 March 2005 was prepared in accordance with the methodology of the International Monetary Fund GFS 2001 (Government Finance Statistics) whereas the subsequent report, dated 1 April 2006, marked the transition to the ESA methodology.

The ability to predict and control future spending is instrumental in improving budget preparation processes and maintaining/reducing public expenditure levels within the envisaged macroeconomic framework. In taking forward this work, it is important that the financial impact of any proposed changes on the state and other budgets be addressed as early as the legislation-drafting stage. The central bodies of state administration and administrative and technical services of the Government of the Republic of Croatia (hereinafter, the Government) are thus required to enclose a statement on the projected impact of proposed legislation on the State Budget, local and regional self-government budgets and the number of civil servants and employees when submitting their legislative and regulatory proposals to the Croatian Government for approval (the same applies to any laws and acts that the Government submits to the Parliament for adoption).

Efforts to create instruments to support and advance a multi-year approach to budget planning have also been made. The Ministry of Finance draws up guidelines on economic and fiscal policy (or fiscal policy principles) by the end of April to provide a comprehensive macroeconomic framework and fiscal objectives for a three-year period. With a view

1 : ESA 95 was introduced in 1996 by Council Regulation (EC) No. 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community (Official Journal L 310 of 30.11.1996) to ensure common standards, definitions, classifications and accounting rules intended to be used for compiling accounts and tables on comparable bases for the purpose of the Community.

2 : The modified accrual-based accounting principle means that:

- revenues are recognized in the reporting period in which they are received, provided that they are measurable;
- expenditures are recognized when incurred in the reporting period to which they relate, regardless of whether actually paid;
- depreciation of non-financial long-term assets is not an expense; it is recorded as the adjustment of the value of assets in the balance sheet;
- changes in the value of non-financial assets are not considered expenditure or revenue;
- donations of non-financial assets are not classified as revenues or expenditure.

1.

Introduction

to ensuring a fiscally and socially sustainable medium-term budget, the guidelines also include limits on the size of expenditure in the financial plans of line ministries and government agencies for the coming three-year period. The limits apply to all sources of finance that affect the level of deficit, and are a key precondition for successful budget preparation.

A significant move towards programme budget classification was made in 2003, with the adoption of a more comprehensive approach to programme budgeting. The Croatian budget has a very detailed account structure with approximately 7,000 line items, classified into programmes that are further broken down by activities and projects. Some flexibility is maintained through a provision in the Budget Act that allows reallocation of funds between budget lines and between budgetary users for an amount of up to 5% of the concerned item, subject to the approval of the Minister of Finance.

The State Budget coverage was expanded in 2006 to incorporate lottery revenue, road charges, own revenues of budgetary users, revenues under special regulations (administrative fees and other earmarked revenues) and EU grants. All programmes, activities and projects were thoroughly elaborated in a supplement to the budget presented to the Parliament in order to provide a better understanding and clearer overview of the goals and purpose of each programme and work carried out by individual ministries. The planning system has facilitated greater control over the collection and use of earmarked revenues.

Pursuant to the provisions of the Budget Act³, the State Budget has one account for all payments. Public expenditure management is operated by the State Treasury via the Treasury Single Account (TSA) through which all financial transactions of the State Budget are executed. The accounts of line ministries and other government agencies were closed in 2006, and the accounts of extra-budgetary users (i.e. health, retirement and employment funds) soon followed suit at the beginning of 2007. All budgetary revenues and receipts are channelled into the TSA, from which all payroll and current and capital expenditure payments are made. Such a setup facilitates daily liquidity management and provides a solid basis for effective financial planning. The implementation of the TSA allows rational management of public funds, without infringing on the autonomy of budgetary users in the use of their resources. Budgetary users still manage their revenues and expenditures towards goals and objectives identified in their plans.

3 : Official Gazette of the Republic of Croatia (*Narodne novine*), no. 96/2003.

In order to extend the functionality of the State Treasury, project documentation has been prepared for the development of an integrated information system for accounting and financial management. Once the system is implemented, the Treasury will have access to a most highly developed accounting system with complete data on all commitments, liabilities and due dates. In the meantime, obligations of budgetary users are monitored through their monthly liabilities reports. The design of the integrated financial management information system is a result of a set of comprehensive studies and analyses, the most important of them being the Rationalization Study, which were conducted to provide evaluations of financial and information systems of all ministries in order to establish the potential of their integration with the target system architecture.

Functionally independent units of internal audit have been established in all ministries, budgetary users and the City of Zagreb. Financial management and control is being implemented in all organizational units and for all levels of budgetary users to encompass all budgetary resources, including EU funds and other resources. The Central Harmonization Unit (CHU) within the Ministry of Finance has developed a system of education and certification of internal auditors in the public sector and laid the groundwork for the development of a similar employee training and development scheme for financial control and management.

The above changes are all part of the ongoing reform efforts geared towards improving public revenue and expenditure and public finance management. Although they have been generally well-received, the scope and effect of the changes is hampered by the lack of a common institutional framework so they remain largely technical and methodological in nature. The purpose of this document is to create such framework, lay down institutional foundations and formulate a strategy for managing the reform of public finances.

Strategy for the Development and Modernization of the State Treasury 2007 – 2011. This is a core development document of the Croatian Government for public finance management. Its objectives and content are largely dependent on the period to which it refers, which is the period of negotiations for the accession of the Republic of Croatia to the EU, extending into the first few years of full EU membership.

Reflecting the role of the State Treasury as the point of organizational and informational integration of key budgetary processes (namely: budget preparation and execution, accounting, reporting and public debt management), this Strategy lays down goals for the modernization of the State Treasury system, as well as short- and medium-term measures for their achievement. Ultimate responsibility for the implementation of these measures rests with the Ministry of Finance.

1.

Introduction

This document is organized as follows: Chapter 1 is this Introduction, which is followed by a chapter that defines the concept of State Treasury and outlines the goals of the Strategy. Chapter 3 is the focal point of the document, devoted to the core budgetary processes. Within each chapter, an analysis of the present state of affairs is followed by a list of identified areas for improvement and a spectrum of clearly defined modernization measures. The Strategy then focuses upon vital issues in connection with the development of internal financial controls, continuing with a chapter that determines the course of further development of the integrated State Treasury information system. The document ends with a discussion on changes that will have to be made to the existing legal and organizational framework to allow and support the implementation of these reform efforts.

The Strategy for the Development and Modernization of the State Treasury draws on the Strategic Development Framework for 2006 – 2013, as the key strategic document of the Croatian Government, and other Government documents pertaining to the area of public finances, notably: National Programme for the Integration of the Republic of Croatia into the European Union, 2007 – 2009 Pre-accession Economic Programme, and National Anti-corruption Programme for 2006 - 2008.

The need for public finance management reform is evident in all developed countries and is not a typical transition agenda. There is, however, no clearly defined “recipe” for the implementation of changes. We need to draw from the best practices of the countries that pioneered the process of reform and use their years of experience in this area. There are also some general principles to follow as a result of integration and globalization tendencies, established largely by the OECD and International Monetary Fund. The Strategy draws on these general principles and best practices.

Finally, a sincere effort has been made to incorporate our past experience in the development of the State Treasury system, as well as recommendations and advice of SIGMA⁴ experts (a joint initiative of the OECD and EU) regarding the objectives and the structure of this document.

⁴ : Support for Improvement in Governance and Management.

2. Goals of the Strategy for the Development and Modernization of the State Treasury

2.1. Definition and organization of the State Treasury of the Republic of Croatia

The State Treasury can be defined as a set of organizational functions aimed at providing efficient public expenditure management through:

- efficient and effective use of public funds, i.e. taxpayers' money, and
- fiscal discipline.

The basic functions of the Croatian Treasury are: budget preparation, budget execution, cash management; financial planning and forecasting, management of government bank accounts, revenue management, government reporting, budget accounting and public debt management.

The Treasury is set up as an administrative unit within the Ministry of Finance.

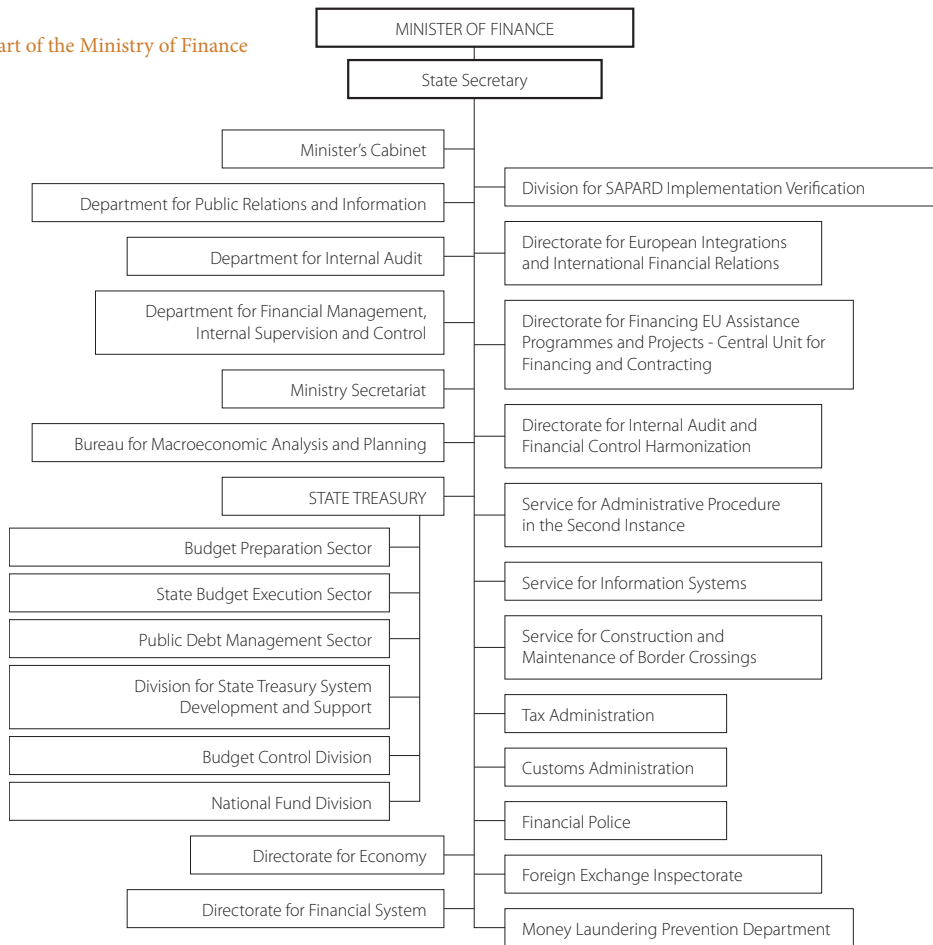


Strategy for the
Development
and
Modernization
of the State
Treasury
2007 - 2011

2.
Goals of the Strategy for the Development and Modernization of the State Treasury

2.1. Definition and organization of the State Treasury of the Republic of Croatia

Figure 1:
Organizational chart of the Ministry of Finance



Decree on the Internal Organization of the Ministry of Finance; Official Gazette nos. 43/05, 114/05, 14/06 and 138/06

2.2 Goals of the Strategy

The State Treasury, from the aspect of its functionalities, belongs to the context of public financial management. There are three main areas of public financial management⁵: 1. fiscal management; 2. resource allocation; 3. value for money. Fiscal management refers to the management of revenues and expenditure flows, balance-sheet items, assets and liabilities (debt in particular) and risk management of contingent liabilities. The goal of resource allocation is to achieve optimal resource allocation in accordance with government policies. Value for money is a concept of public funds management based on performance measurement and the principles of high efficiency and effectiveness in use of public money.

The State Treasury supports and assists in the achievement of the key objectives of public financial management: 1. proper use of public resources in accordance with legal and regulatory requirements; 2. transparency of the system (providing information for stakeholders in a format that facilitates understanding and further analysis); 3. a working system of accountability.

Without sustainable changes in public finance management and consistency of reforms, ensured by a clear timeframe and a well-defined set of priorities, there is a risk that the Government will face permanent fiscal stress and other unforeseen crises. The goal of this Strategy is, therefore, to identify individual reform components and their inter-dependencies, establish priorities and suggest a time-frame for the implementation of reform activities, together with any legislative changes that may be needed to underpin the process of reform.

The Strategy for the Development and Modernization of the State Treasury is aimed at developing an effective and sustainable financial management system, based on modern instruments and mechanisms that are in line with the requirements and standards of the European Union.

2.
Goals of the
Strategy for the
Development and
Modernization of
the State Treasury

2.2. Goals of the
Strategy

⁵ : Michael Parry, IMCL (International Management Consultants LTD), Why governments need Integrated Financial Management Systems, <http://www.icgfm.org/downloads/2004miami/Parry.ppt> .

2.

Goals of the Strategy for the Development and Modernization of the State Treasury

2.2. Goals of the Strategy

This means improvement of the current system of public expenditure management across different levels, notably:

- 1. At the state level**, it is necessary to **strengthen the overall fiscal discipline** in order to ensure and maintain macroeconomic stability. This task, inter alia, requires detailed and comprehensive macroeconomic analyses and some form of a multi-year budget framework to maintain the sustainability of current programmes and public debt policy.
- 2. At the inter-sectoral (inter-ministerial) level**, it is necessary to **ensure effective inter-sectoral allocation of resources, i.e. an allocation of resources** consistent with the strategic priorities of the State. Institutional solutions and tools for enhancing strategic allocation of resources include the top-down development approach to budgetary planning and the development of a multi-year budget framework.
- 3. At the programmatic/managerial level**, it is necessary to **coordinate budgetary authorizations and operative effectiveness**.⁶ To achieve this, it is necessary to strike the right balance between flexibility during the execution phase of the Budget and budgetary restraint. The measures proposed in this Strategy will thus be directed towards strengthening fiscal controls, improving inter-sectoral allocation of resources and providing greater flexibility for effective management and the development of accountability mechanisms.

⁶ : Provedbena učinkovitost odnosi se na efikasnost i efektivnost pružanja javnih usluga.

Table 1: Goals of the Strategy for the Development and Modernization of the State Treasury

Objectives		Tasks
Fiscal discipline	Macro-fiscal level	<ul style="list-style-type: none"> • Development of medium-term budget framework. • Budgetary planning under hard financial constraints. • Debt management and better fiscal risk management.
	Programme management	<ul style="list-style-type: none"> • Extension of TSA. • Comprehensive accounting and reporting. • Further development of PIFC (Public Internal Financial Control).
Strategic resource allocation		<ul style="list-style-type: none"> • Improved quality of budget planning procedures and instruments • reinforce link between budget and policy; • create robust budget classification system; • continue progressive development of programme budgeting.
Efficient service delivery Value for money		<ul style="list-style-type: none"> • Streamlined rules for transfers between line items. • Reduced costs of financial transactions: TSA. • Further development of PIFC. • Development of performance indicators, starting with pilot ministries.

2.
Goals of the Strategy for the Development and Modernization of the State Treasury

2.2. Goals of the Strategy

3. Modernization of processes

3.1. Budget preparation

3.1.1. Budget formulation

The present state of affairs

The Ministry of Finance has begun work on the development of a long-term approach to budget planning. By the end of April, the Ministry drafts a document called Economic and Fiscal Policy Guidelines, with a view to defining the macro-economic framework and fiscal policy goals for a three-year period.

The Guidelines include:

- premises for socio-economic development for the budget year and the following two years;
- basic indicators of Croatia's fiscal and economic policy;
- an estimate of revenues and expenditures, and receipts and expenses for all government levels;
- a framework proposal of the scope of budgetary users' financial plans for the preceding, current and the following budget year, and for the following two years.
- projected changes in assets of the central, regional and local governments, and debt of regional and local governments;
- an overview of central government obligations due to be met in the coming years and the policy plan for the development/investment programmes.

To ensure a fiscally and socially sustainable medium-term budget, the Guidelines also include limits on the financial plans of line ministries and government agencies for the following three-year period. The limits apply to all sources



Strategy for the
Development
and
Modernization
of the
State Treasury
2007 - 2011

of finance that affect the level of deficit, and are a key precondition for successful budget preparation. The purpose of these activities is to provide a solid basis for the development of a sound fiscal policy. The Guidelines are submitted to the Government for adoption.

In accordance with the adopted guidelines, the Ministry of Finance develops Instructions for the Preparation of the State Budget Proposal and issues them to budgetary users and users of extra-budgetary funds. When preparing their financial plan proposals, budgetary users are compelled to observe these Instructions, especially the established ceilings, as well as any relevant provisions of the Budget Act and implementing regulations.

Budgetary users' financial plan proposals include revenue estimates listed by type and expenditure estimates classified by programmes, activities and projects for the coming three-year period, together with an explanation of the financial plan. For each activity and project, sources of finance must be determined as well.

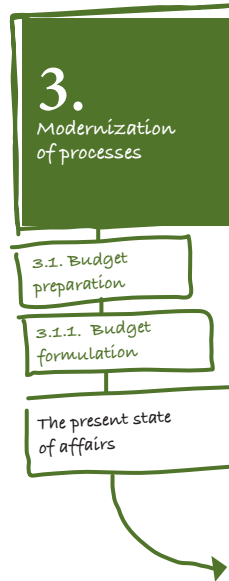
Budgetary users deliver their proposals to the responsible ministry no later than 15 June of the current year. Ministries and other government agencies then forward them to the Ministry of Finance by the end of the same month.

The Ministry of Finance reviews the proposals and adjusts them to the estimated figures, drafts the State Budget and the budget of consolidated central government for the coming budget year and submits the drafts to the Cabinet no later than 15 October of the current year.

If during the negotiations on the State Budget proposal a disagreement arises between the Minister of Finance and a budgetary user (or the responsible line minister), the Minister of Finance prepares a statement for the Prime Minister who then makes a final decision.

The Government has to submit the draft State Budget and consolidated budget to the Croatian Parliament for adoption by 15 November of the current year. The Croatian Parliament enacts the budget by the end of the current year for the next budget year, effective January 1 of the year to which the budget relates. Although the Guidelines do provide framework for a multi-year budget approach, the State Budget is passed for only one budget year.

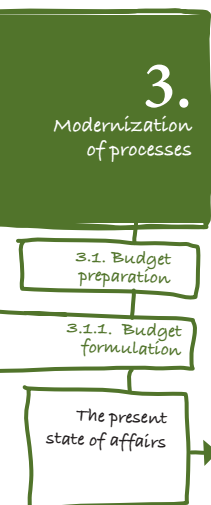
During parliamentary debate on the State Budget proposal and financial plans of extra-budgetary users, Members of Parliament present their proposals for amendments, which the Government may adopt or reject. An amendment proposing an increase in expenditure above the amount established in the Budget proposal may only be accepted if



it is financed by a commensurate cut of another item of expenditure, but not from budgetary reserves or additional borrowing. Adopted amendments may not exceed the projected deficit of the consolidated budget of the Republic of Croatia.

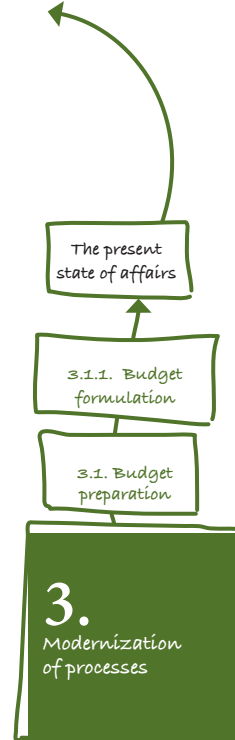
Table 2: Budget formulation process

DUE DATE	ACTIVITY AGENT	ACTIVITY
End April	Ministry of Finance	prepares Economic and Fiscal Policy Guidelines for a three-year period and submits it to the Government.
Mid May	Government	enacts budget guidelines.
Mid May	Ministry of Finance	issues Instructions for the Preparation of the State Budget Proposal to budgetary and extra-budgetary users.
15 June	Budgetary users	deliver their financial plan proposals to the responsible ministry.
End June	Responsible ministries	deliver adjusted financial plan proposals to the Ministry of Finance.
15 October	Ministry of Finance	prepares draft state budget and draft consolidated state budget for the coming budget year and presents it to the Government.
15 November	Government	adopts the national budget for the coming budget year.
End December	Parliament	adopts the national budget for the coming budget year.



The evident need for better efficiency of budget preparation and stronger role of the Ministry of Finance in the budgetary process has resulted in the introduction of a mechanism for the assessment of financial impacts of legislation on the national Budget. The ability to predict and control future spending is instrumental in improving budget preparation processes and maintaining/reducing public expenditure levels within the envisaged macroeconomic framework. The responsibility for the assessment of costs and benefits of proposed legislation with respect to budgetary programmes, activities and projects rests with the state agency and increases awareness and accountability of the Government and Parliament for the financial consequences of legislation they enact.

The Decision on Standard Methodology for Financial Impact Assessment came into force in 2005. It prescribes the content and the manner in which the assessment is to be completed and presented. The central bodies of state administration and administrative and technical services of the Government of the Republic of Croatia are thus required to enclose a statement on the projected impact of proposed legislation on the State Budget, local and regional self-government budgets and the number of civil servants and employees when submitting their legislative and regulatory proposals to the Croatian Government for approval (the same applies to any laws and acts that the Government submits to the Parliament for adoption).



Scope for development and modernization

1. A clear link needs to be established between the budgetary process and legislative, strategic and programme guidelines defined by the Government and Parliament.

A more explicit top-down budgeting approach is missing to create a multi-year fiscal strategy. An integration of strategic and budgetary planning is necessary if decisions on budget allocations are to be a transparent reflection of the strategic priorities and goals of the Croatian Government. An ideal integration of strategic and budgetary planning is shown on the left side of the below diagram whereas the right side shows the existing situation. The main weakness of the current model lies in the separation of strategic and budgetary planning processes and a lack of systematic evaluation policies.

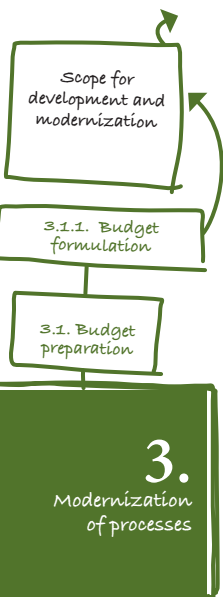
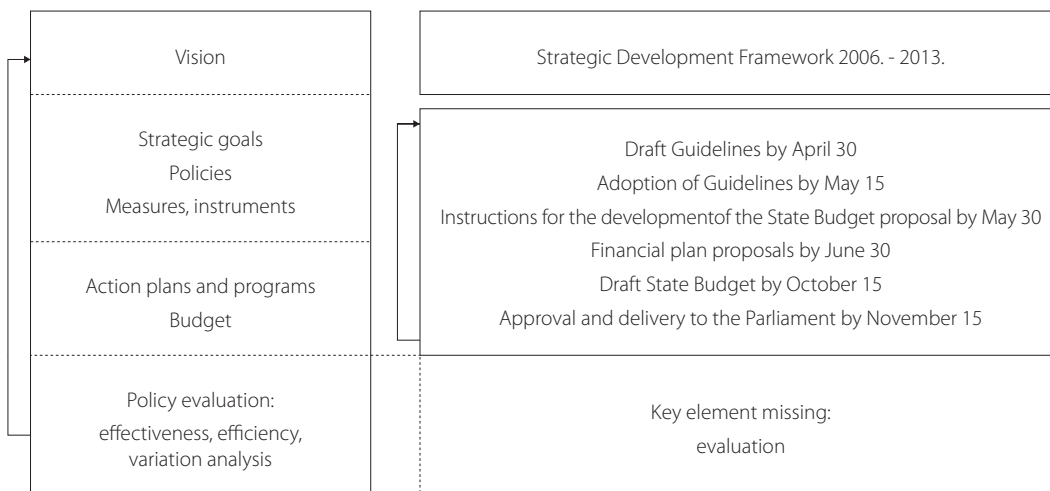


Diagram 1:

Comparison of the desired (left) and current (right) processes of strategic and budgetary planning.



Goals:

- *Top-down budget perspective.*
- *Strong link between budget allocations and strategic priorities and policy objectives of the Government.*
- *Develop multi-year budgeting approach.*

2. Budgeting time frame – single-year approach

Although the State Budget is planned for a three-year period, it is passed for only one budget year. Estimates of revenues, receipts, expenditures and expenses from the multi-year framework adopted during the preceding year are not taken into account in the preparation of the annual budget. Budgetary documents should contain thorough explanations on how the line item estimates for the budget year and the ensuing two years relate to the previous year's multi-year estimates. This information is currently lacking, which makes the assessment of budget proposals more difficult.

Modernization measures

- Significant efforts in strengthening the Croatian system of budgeting will be directed towards the **transition to a top-down budgeting approach**, based on strategic goals and Government priorities in a given period.

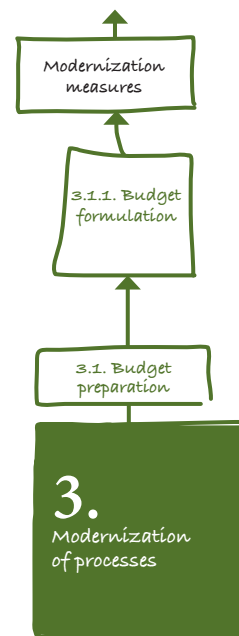
A sound approach to strategic planning recognizes that resources are limited and that the Government simply cannot afford to do everything. The planning process should provide a mechanism that would assist the Government in identifying priorities and ensuring that adequate resources are allocated to meet them. The **integration of established priorities and budgetary processes** would significantly increase the government's ability to meet its obligations in a timely fashion.

- **Create a comprehensive database of all adopted strategies, national programmes and other Government policy documents.**
- Strategic priorities and policy objectives of the Government should have a direct bearing on the allocation of budgetary funds. To achieve this, it is vital that parallel with the fiscal plan a **three-year government policies strategy (Financial Strategy)** be introduced. The Financial Strategy should contain clearly defined priorities, goals and policies to be incorporated in the annual budgets covered by the three-year period in question. Such a strategy would greatly help in explaining proposed budget allocations and would be presented in support of the State Budget to the general public and Members of Parliament.

The Strategy would draw on three-year strategic plans of line ministries and would have to be submitted to the Croatian Parliament for adoption.

At the negotiations stage of the budget formulation process, where the financial plan proposals of line ministries and other government bodies are discussed and agreed, a clear link must be established with the adopted Financial Strategy.

- **Develop instructions and forms for strategic planning** to support the implementation of the Financial Strategy.
- **Select pilot ministries to initiate the preparation of strategic plan proposals** based on new instructions and forms.
- **Educate budgetary users** in the area of strategic plan development.
- The preparation of the Financial Strategy and other activities for the integration of strategic and budgetary planning

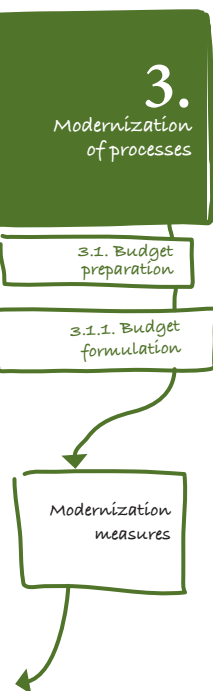


will require **a close cooperation with the Central Office for Development Strategy and Coordination of EU funds**, which performs expert and administrative tasks related to the formulation of the Development Strategy of the Republic of Croatia and monitors the implementation of the objectives established by the Strategy.

- The top-down perspective cannot be achieved without a medium-term fiscal framework, which should lay down medium-term fiscal goals of the Government with respect to key indicators (such as total revenues, expenditure, public deficit, public debt and the cost of debt-servicing) and give an overview of all material risks, quantified to the extent possible. The framework should also include medium-term expenditure projections, which should be consistent with the established revenue targets and budget deficit and further broken down into proposed spending by current and planned Government activities. Medium-term fiscal goals should be set to avoid permanent fiscal stress on the Government and Parliament so as to ensure sustainable fiscal development of the country and clearly identify future fiscal impacts of current decisions.

A **medium-term budget framework (MTBF) is to be prepared** to ensure the sustainability of budget policies and plan for policy changes. Budget requests (i.e. financial plans) of line ministries even now include medium-term expenditure estimates but these are not used in the budgeting process.

- **Establish procedures for the preparation of MTBF** and revise the budget formulation procedure to take account of MTBF procedures.
- Preparation of the medium-term budget framework will require a close cooperation with **the Macroeconomic Analysis and Planning Bureau** (which provides projections of fiscal aggregates) and the State Treasury. The Macroeconomic Analysis and Planning Bureau is also responsible for preparing economic and fiscal policy guidelines and identifying policy priorities for a three-year period, which are currently in the form of rather broad policy statements.
- The introduction of Financial Strategy development based on ranked strategic priorities and Government objectives will directly affect the content of economic and fiscal policy guidelines for a three-year period. As things currently stand, targets indicated in the guidelines do not apply to programmes but to organizations and functions (according to organizational and functional classification), which does not allow for meaningful, performance-oriented discussions on budget allocations. **The guidelines should use programmes as a critical starting point in reporting and establishing indicative targets/ceilings** for expenditure items (economic classification).



MTBF is a tool for better fiscal risk management in a multi-year perspective. By strengthening the process of strategic decision-making, it also ensures more efficient resource allocation. It is a process that is repeated every year with the purpose of reducing the gap between what is available and what budgetary users want. This is achieved by establishing effective links between policy-making and budget planning early in the budget cycle and by doing necessary adjustments to accommodate policy changes. A well-implemented medium-term budget framework should: a) link Government priorities to the budget within sustainable level of spending; b) highlight trade-offs between competing Government objectives; c) link the budget to adopted policies, strategies, programmes and legislation; d) improve outcomes by increasing transparency, accountability and predictability of funding.

Modernization measures

3.1.1. Budget formulation

3.1. Budget preparation

3.
Modernization of processes

3.1.2. Budget classification/Budget structure

The present state of affairs

Classifications are the basis for consistent recording of financial transactions. They facilitate control over expenditures and allow for economic and statistical analyses to be made. Standard classifications must be developed to provide a basis for integrated planning, execution, recording and consolidation. In treasury systems with developed classifications, data is entered into the system only once and can be used for various purposes without having to be re-entered.

The Budget Act identifies the following types of budget classification: organizational, economic, functional, location and programme. All revenues, receipts, expenditure and expenses in the budget and in the financial plans of budgetary users must be reported in accordance with these budget classifications.

Organizational classification is a presentation of expenditures and expenses according to the organizational structure of the central government and local and regional self- governments, broken down by first and second level budgetary users. Economic classification consists of revenues and receipts classified by economic type, and expenditures and expenses classified by the economic purpose they serve. Functional classification is a set of operations, functions and programmes of the central government and local and regional governments, organized and classified by purpose. Location classification presents expenditures and expenses according to the territorial organization of the Republic of Croatia whereas programmatic programme classification is a presentation of budget programmes and their integral parts — activities and projects.

While sources of finance do not fall under the types of budget classifications as laid down in the Budget Act, their definition was an important premise for the full implementation of the Treasury Single Account.

Three-year revenue and expenditure estimates are thus categorized into the following sources of finance: 1 General revenue and receipts, 2 Social contributions, 3 Own resources, 4 Special purpose revenues, 5 Grants, 6 Donations, 7 Special-purpose receipts from borrowing.

Source of finance: general General revenue and receipts is comprised of revenues from taxes, revenues from assets, revenues from administrative fees and charges, revenues prescribed by special regulations (not earmarked), revenues

3. Modernization of processes

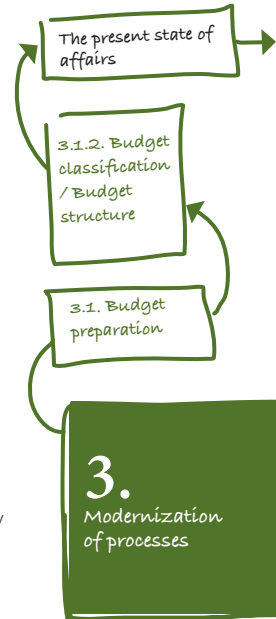
3.1. Budget
preparation

3.1.2. Budget
classification
/ Budget
structure

The present
state of affairs

from fines and penalties, income revenues from the sale of non-financial assets and insurance claims and receipts from financial assets and borrowing. Budgetary users here include budgetary revenues from which they finance their day-to-day business operations. Source of finance: Own resources are comprised of revenues earned by providing services on the market (i.e. in market competition with other physical or legal entities, under market conditions). Source of finance: Special purpose revenues are revenues whose use and purpose are prescribed by special regulations. Source of finance: Grants are transfers received from foreign governments, international organizations (EU grants), other budgets and general government units. Source of finance: Donations are income revenue received by individuals, non-profit organizations, companies and other entities outside of general government. Source of finance: Special- purpose receipts from borrowing comprises proceeds from borrowings, whose use is restricted by special contracts and/or legal provisions.

Sources of finance are not exclusively connected with revenues and receipts. Expenditures and expenses are classified by programmes, projects and activities and sources of finance are given for all activities and projects.



Scope for development and modernization

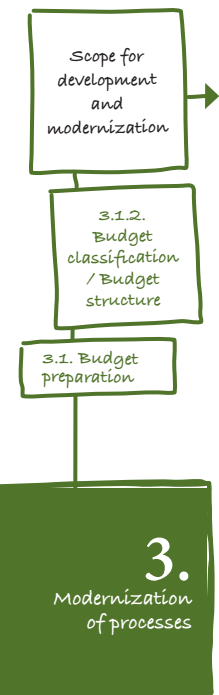
1. Mixed approach to defining different levels of organisational classification

Current organisational classification does not follow the structure of legally defined areas of competence. Ministries, agencies, funds, commissions, inspectorates, government departments etc. are all at the same (first) organizational level. Every year the number of first-level budgetary users increases as newly-established government institutions ask to be granted the first-level status, assuming that it would give them autonomy in managing their part of the budget. Nevertheless, organisational classification should be aligned with the established areas of competence.

At the second level, there is a mixture of organisational, functional and programme classifications.

2. Orientation towards programme classification

The key problem with the budget preparation process is a quick transition from line-item budgeting to programme budgeting. Programme budgeting is not only about consolidating spending into activities, projects and programmes,



as most budgetary users seem to believe, but about a major shift of the methodological focus from the type and size of expenditure towards expected outcomes and results.

3. Detailed budget structure

The national budget has a very detailed account structure with approximately 7,000 line items, classified into programmes that are further broken down by activities and projects. Some degree of flexibility is maintained through a provision in the Budget Act that allows reallocation of funds between budget items and between budgetary users for an amount of up to 5% of the concerned item, subject to the approval of the Minister of Finance.

The State Budget is adopted by the Croatian Parliament at the fourth level of the Chart of Accounts. This level of disaggregation results in frequent reallocations during the execution phase of the budget.

The implementation of basic elements of strategic planning, medium-term fiscal framework and programme budgeting imposes more direct accountability on ministries and other state administration bodies to deliver performance targets. However, due to excessive level of disaggregation, the budget does not provide users with sufficient flexibility to manage their resources, which is evident from a high number of reallocations during the fiscal year. Such a rigid system of controls serves no real purpose as it does not help in achieving better programme implementation results nor does it improve the efficiency and effectiveness of public service delivery.

Goals:

- *Adopt budget at a higher level of the Chart of Accounts.*
- *Redefine organisational classification and budget coverage.*
- *Rationalize programme classification.*

Modernization measures

- Ensure **budget adoption at a higher level of the Chart of Accounts**. Budgetary users' financial plans and the draft State Budget would still be prepared at the fourth level of the Chart of Accounts. The Parliament would adopt the State

Budget at a higher level of the Chart of Accounts than the current fourth level, which would allow for more flexibility in budget execution. The State Budget Execution Report would remain at the fourth level.

- **Align organisational classification with legally defined areas of competence and establish criteria** for determining the level of organisational classification of budgetary users.
- **Redefine programmes** so as to reduce their number, align them with the strategic framework and determine their measurability.

3.1.3. Programme budgeting

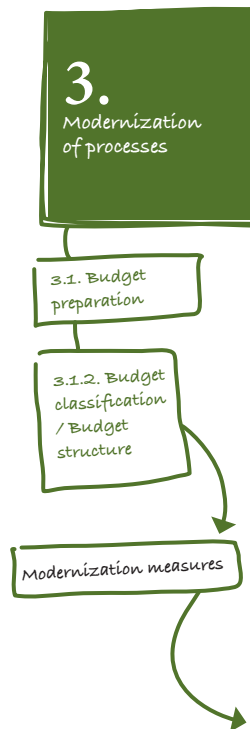
Since the introduction of programme classification in 2003 and a more earnest approach to programme planning, the central government and local and regional governments have been working hard on the implementation of a sound system of programme budgeting. It is important to understand here that budget planning should not be viewed in isolation from other budgetary processes, particularly budget execution and accounting. All budget programmes (projects and activities) must be tracked in the accounting system to ensure financial information on their performance in achieving established targets. This need for performance measurement and reporting calls for strong links between budgeting and accounting processes. It is thus important to make sure early in the programme formulation phase that the accounting system is capable of generating information to support performance assessment of approved budgetary programmes.

However, despite considerable efforts made by the Ministry of Finance and budgetary users themselves, the approach to programme structure preparation and formulation of specific goals and objectives for individual programmes still appears to be largely formalistic.

Scope for development and modernization

1. Input-oriented budgeting

The current budgeting approach is still largely input-oriented so the outcomes expected from the implementation of





specific programmes basically take a back seat. More effort is spent on identifying deviations between actual and planned budgetary items than on monitoring programme results and their effects on the quality, efficiency and effectiveness of the delivery of public goods and services.

Goals:

- *Create conditions for measuring effectiveness of public spending (efficient use of public resources).*
- *Increase budgetary users' responsibility for purposeful and effective spending of public funds at all stages of the budget process.*
- *Improve quality of program budgeting procedures and instruments.*

Modernization measures

- **Link planning with other budgetary processes**, accounting and budget execution in particular.
- **Define programme monitoring and evaluation (assessment) procedures.**
- **Define performance indicators.** The first step in the implementation of programme budgeting, which began with the application of programme classification, is to be followed by the introduction of appropriate performance indicators with a view to establishing a system of accountability for results. Because of their complexity, the implementation of these modernization measures will be initially restricted to pilot ministries.

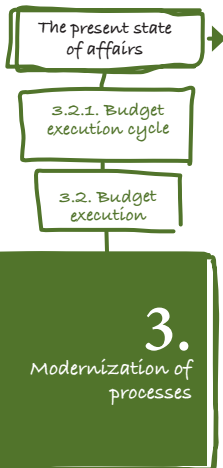
Performance indicators allow us to measure, monitor, assess and improve programme performance. They are instrumental in managing performance at all levels within the organisation (strategic and operative). The aim of performance measurement is to achieve continuous improvement: performance indicators are used to determine the extent to which a performance target is being achieved and efficiency of services provision in the context of how it contributes to the achievement of specific targets. Performance indicators help public sector managers to identify pressing issues and improve public service delivery. Another important benefit of performance indicators is that they increase transparency and managerial accountability for results. They allow insight to the Government, Croatian Parliament and the general public into the work and performance of state administration bodies.

Modernization
measures

3.1.3. Programme
budgeting

3.1. Budget preparation

3.
Modernization of
processes



3.2. Budget execution

3.2.1. Budget execution cycle

The present state of affairs

Budget execution is one of the core functions of the State Treasury. To achieve this functionality, a system has been developed where budgetary users submit their requests for payment to the Treasury, which reviews the requests for compliance with the amounts decided in the budget and plans their payment. This ensures that public funds are not used for other than intended purposes. The stages of the budget execution process are: monthly cash plans, cash allotments, reservations, requests for payment and payment.

Cash plans

In accordance with the amounts decided in the budget, budgetary users divide the allocations over the twelve months of the budget year and submit an annual financial plan divided by month. Budget liquidity is planned on the basis of these monthly cash plans, which must be in compliance with the annual plan and available funds.

Allotments

Monthly cash allotments are determined no later than ten working days prior to the beginning of the period to which they relate (20th day of the month). The Ministry of Finance makes monthly cash allotments in accordance with budget liquidity targets and assumed commitments of the budgetary user, up to the amount planned in the annual financial plan of the budgetary user.

The procedure and requirements that must be observed in determining cash allotments and measures for non-compliance are set out in the Rulebook issued by the Minister of Finance.

Revised cash plans

Budgetary users adjust their cash plans to the allocated monthly cash amounts, no later than the 20th day of the month

for the following month. The Budget Execution Department in the central Treasury approves the revised plans by the 25th day of the month so the funds can be released for spending. New reservations of funds (and requests for payment) are entered into the system within planned limits.

Reservations

Liquidity management practice requires that reservations of funds for liabilities due to be paid within the current budget year be made on the basis of the maturity date of liabilities.

Payment requests

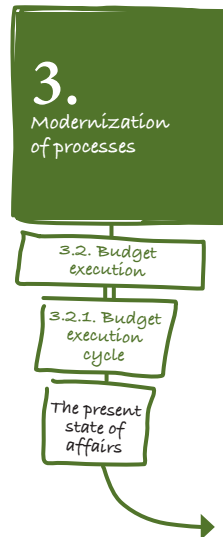
A request for payment is a book-keeping document whereby the budgetary user issues an order to the State Treasury to effect payment from the treasury account for incurred liability. All costs and expenditure covered by the budget must be supported by valid accounting documents that prove the amount and existence of incurred liability. Payment requests are signed by the financial controller and payment authorizing officer (i.e. payment certifier). The controller is responsible for the lawful execution of the budget head's orders in a manner that conforms to the financial and accounting regulations. The controller checks the validity of the liability, whether the service was rendered or goods delivered in accordance with the order and expectations and whether the creditor is correctly identified.

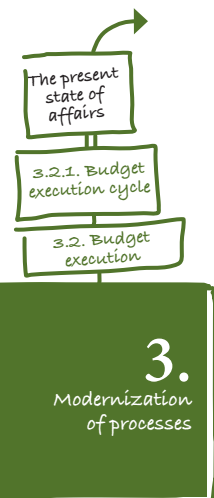
Accounting control is performed at the budgetary user level before the payment request is submitted.

Accounting control includes the following measures and procedures:

- determining the validity of the existence of the liability;
- establishing whether the service was performed, i.e. whether the goods were delivered in accordance with the order and expectations;
- determining the validity of the document as the basis for the payment request entry.

Accounting control also includes verification of the procedures for the procurement of goods and services and contracting of works pursuant to regulations governing the matter. The accounting control procedures are conducted by the authorized person of the budgetary user. After the validity of the existence of the liability has been established, the payment authorizing officer signs the request for payment.





The State Treasury (i.e. the responsible person in the Budget Execution Sector) approves payment requests on the basis of planned inflows and payment maturities.

Financial control over the management of funds in the single account is performed at the level of the central Treasury.

Financial control at the State Treasury verifies the following:

- the availability of funds for the entered reservation within the monthly planned amount;
- alignment of the purpose with the budget,
- financial compliance with the monthly limits set in the budget.

The financial controller performs the above control procedures and is responsible for the correct authorization of the payment request. The financial control procedure makes sure that the funds approved in the budget for the current fiscal year are justified and documented.

Early warning mechanisms

In 2005, budget execution assessment was introduced. Budgetary analysis is done for all budgetary users on a monthly basis, before the decision on monthly allotments is made. The following is assessed:

- monthly budget implementation from 2003 through 2006;
- implementation of the annual budget from 2003 through 2006;
- comparison plan-implementation and implementation-implementation for 2005 and 2006;
- comparison plan-implementation for 2006 by activities and economic classification.

Depending on the findings of the assessment, the Ministry of Finance issues a written warning to the budgetary user, requesting explanations for any deviations from the expected pace of budget execution with respect to the items specified in the letter. The decision on the monthly allotment is based on the assessed level of budget execution (payments+reservations) and trends in arrears⁷.

Budget implementation by sources of finance

Budget execution methodology reflects the need for monitoring budget implementation by sources of financing.

⁷ : Obligations of budgetary budget users are monitored through their monthly Liabilities Report.

Various control measures and modern mechanisms in line with the financial regulations of the EU have been introduced concerning the execution of expenditures by sources of finance, such as the following:

- possibility to carry over obligations financed from revenue associated with the sources whose use is predefined;
- control of spending on the basis of the outturn of revenue earmarked for a specific purpose;
- securing of general revenue to meet mandatory budget expenditure.

Treasury Single Account

The introduction of the Treasury Single Account does not imply the loss of autonomy for budgetary users to manage their resources but rather represents a consolidation of the system of financial management (cash flow management). The Treasury thus provides cash security for all budget activities that are approved in accordance with the budget adopted for a given fiscal year. The purpose of the implementation of a single account is to rationalize the way public money is managed, and not to challenge the right of budgetary users to manage their resources. Their right is confirmed by the parliamentary adoption of the Budget.

The Treasury Single Account and its sub-accounts are held with the Croatian National Bank:

1. Treasury Single Account (State Budget Account) – JRR - (1001005-1863000160)
2. TSA sub-accounts:
 - Special purpose sub-account for payroll payments 1001005-15631.....- (sub-account JRR)
 - Special purpose sub-account for current expenditure payments 1001005-15632.....- (sub-account JRR)

Up until 2006, line ministries, central bodies of state administration and government agencies were allowed to hold accounts with the Croatian Postal Bank for revenues from sources other than the State Budget. In the second half of 2007, the accounts of the Croatian health, retirement and employment funds were closed. Third-level budgetary users (such as courts of law, health care institutions, educational, cultural and scientific organizations, etc.) still keep their accounts with commercial banks.

Foreign-exchange account

The implementation of a single foreign exchange account for the execution of foreign currency transactions of the State Budget is vital to the functioning of the Treasury Single Account and efficient cash management.

The present state of affairs

3.2.1. Budget execution cycle

3.2. Budget execution

3.
Modernization of processes

3. Modernization of processes

3.2. Budget execution

3.2.1. Budget execution cycle

The present state of affairs

The foreign exchange account covers foreign-exchange payment operations of the State and budgetary users. The foreign-exchange account enables the Government to issue orders for the payment of: public debt, refinanced obligations of the Republic of Croatia, long-term and short-term loans, obligations arising from state guarantees and debt assumption agreements. Budgetary users use the account for the payment of invoices from suppliers and payment requests entered in the State Treasury information system.

All foreign-currency expenditure is recorded in the State Treasury system.

Foreign-exchange payment requests are effected through authorized banks, either in domestic or foreign currency, in the form of Foreign Remittance Orders (Order no. 14) when issued by the Croatian Ministry of Finance (state operations) or in the form of Payment Approvals for the payment of obligations incurred by budgetary users (budgetary users issue and submit Order 14 to the bank themselves).

The Ministry of Finance keeps regular foreign-exchange accounts with several banks. The highest transaction volumes are handled by the Croatian National Bank and Privredna Bank from Zagreb. Large foreign-exchange payments of the central state are made via Account no. 1810000015 held with the Croatian National Bank. As of January 1, 2006, the following foreign-exchange accounts have been added: Account no. 1810000023 for foreign-currency deposits under succession of the Republic of Croatia; Special-purpose account no. 1510000013 of the Ministry of Science, Education and Sports. A regular foreign-exchange account (with sub-accounts) has been set up for the purposes of the State Treasury with Privredna Bank, which is where the sub-accounts of budgetary users are also held.

Special-purpose foreign-exchange accounts

Pursuant to Article 7 of the State Budget Execution Act and subject to the approval of the Minister of Finance, special sub-accounts for budgetary users may be created to receive foreign funding for projects initiated by the Croatian Government and international monetary institutions. These projects may be funded from loans received under special loan agreements. Foreign loan agreements, like all other international agreements, must be ratified by the Croatian Parliament and then published in the Official Gazette of the Republic of Croatia (National Gazette or „Narodne novine“). Apart from loans, projects may be funded from grants received from foreign governments and organizations, as well as from donations by foreign individuals and legal entities, for which agreements are concluded. All agreements, regardless of the source of finance (loan, grant or donation), include provisions describing how a project is to be implemented.

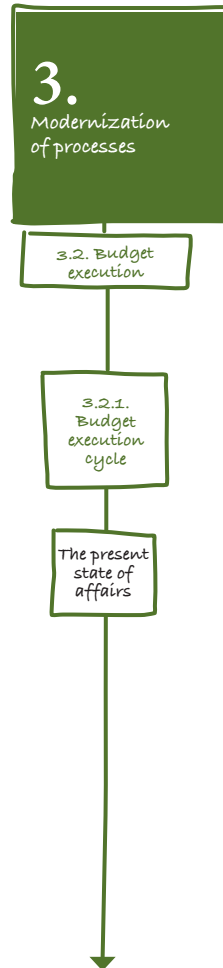
Some of the most important provisions are those that regulate how the funds are to be drawn down and how project costs will be met. All project-related transactions are fully operated (executed) through these special accounts.

Special accounts for loans, grants and donations receivable may be opened with commercial banks. These are, in principle, accounts in the currency of the loan, grant or donation. Before the bank account contract is concluded, the ministry under whose jurisdiction the project beneficiary falls must request a written approval of the Ministry of Finance to open the special account. These special accounts are opened in commercial banks only if so stipulated in the loan/grant/donation agreement and must be closed upon the completion of the project. Bank statements must be delivered to the project monitoring department, project beneficiary, responsible ministry and the Ministry of Finance, and this should be made very clear to the bank at the time the account (any related sub-accounts) is opened.

On the basis of these bank statements, the following procedure takes place:

1. The Ledger of the project beneficiary records:
 - project expenditures and revenue from the loans budget,
 - project expenditures and revenue from grants and donations.
2. In the ministry under whose jurisdiction the project beneficiary falls, payment requests are entered in the State Treasury information system for project expenditures (loans, grants, donations).
3. The Ministry of Finance records:
 - receipts from loans,
 - revenue from grants and donations, and
 - closes payment requests entered in the information system by the ministry responsible for the project beneficiary.

The above procedure has been in operation since the beginning of 2007. It is described in great detail in the Instructions for the Monitoring of Projects Funded from Foreign Loans, Grants and Donations, issued by the Ministry of Finance to State Budget users.



Scope for development and modernization

1. Expand the coverage of the commitment monitoring system

Payment commitments, or reservations, can be recorded in the treasury system just one month in advance, on the basis of monthly cash limits (allotments). Since the timeframe for the registration of commitments is one month, reservations do not contain information on obligations that are due in future periods (months, years...). Reservations are used to provide the Treasury only with information on liabilities that have fallen due whereas information on obligations incurred but due in future periods is obtained via monthly Liabilities Reports that must be submitted within 20 days of the end of the month for the preceding month.

2. Execute all supplier payments directly

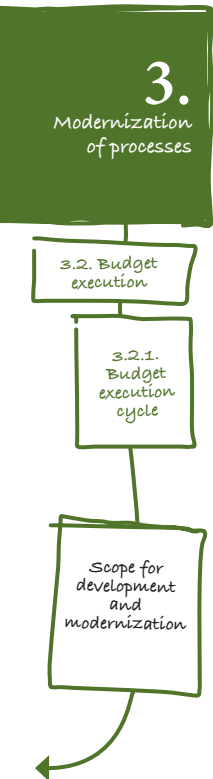
A request for payment does not necessarily mean that the debt settlement payment to the supplier will be made directly into their account because the money can be transferred into a sub-account of the spending agency or TSA sub-account "632".

Direct supplier payments, therefore, need to be made a top priority to ensure highly efficient management of public money. This will require closing sub-accounts and, more importantly, developing interfaces between budgetary users' financial systems and the State Treasury financial transaction and accounting system.

3. Allow invoices received at the end of the year to be carried over

Invoices received at the end of a fiscal year and due to be paid in the coming year are charged to the budget of the coming year. Many projects, capital investment projects in particular, are frequently carried over from one year to another, due to unforeseen delays and difficulties in the tendering process or in the implementation of the project (i.e. progress of works). If a project whose completion was planned by the end of the fiscal year for which funds for the project were appropriated was delayed and the project was completed only at the beginning of the following year, invoices relating to the project cannot be settled until the next year's budget is rebalanced (i.e. revised). This is because budgetary users originally do not plan their budgets to take account of possible delays.

4. Foreign-exchange operations



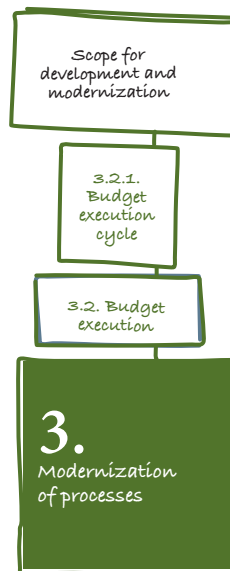
A slow circulation of documents between different sectors within the Ministry of Finance, numerous incoming documentation from budgetary users, various forms (often arriving late), procedures and agreements required to secure guarantees with commercial banks (available resources in the currency of the commitment, conversion into the currency of the commitment, foreign exchange transactions - futures or spot trade) are all elements slowing down foreign exchange operations. The foreign-currency budget execution procedure includes: contacting banks, confirming offered exchange rate, concluding foreign-currency purchase contract, preparing and executing request for payment in kuna (national currency) equivalent based on the bill of sale.

A broad range of transactions and a large number of inputs in this area of the budget execution process call for improved practices and procedures, reduced number of sub-accounts (40 such sub-accounts are being closed), developed Internet technology and better inter-sectoral coordination to decrease the average time between issuing and executing requests for payment and enhance the management of foreign-currency resources.

5. Recording and monitoring transactions in special-purpose foreign-exchange accounts through the State Treasury information system

Foreign-exchange operations are very complex in nature, particularly when information is recorded *ex-post* on the basis of documents submitted to the State Treasury via fax or postal mail. Prior telephone contact between the bank and the user is often required to clear up any issues regarding bank statements, such as when:

a) the user has entered the request for payment but the State Treasury does not have a valid document (bank statement) to close the request; b) the bank has sent the statement but the user has not entered the request for payment in the period when the changes were made. After full documentation is submitted, the bank statement is manually compared against data from the foreign-exchange payment request that was entered in the State Treasury information system (SAP) by the budgetary user. Manual control means that each bank statement item must be checked (amount, date, currency, exchange rate, activity, account, etc.) and matched against the corresponding request for payment in the Treasury system. Only after the validity of the bank statement has been confirmed, data



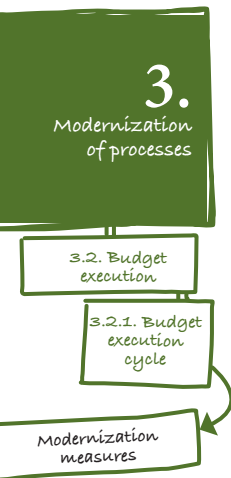
Goals:

- *Introduce accrual-based appropriations and carry-over procedure.*
- *Centralize data on commitments and streamline commitment control.*
- *Increase flexibility in public expenditure management.*
- *Extend TSA coverage.*

can be automatically booked in the SAP system. Such manual and **ex-post** recording of data may give rise to discrepancies between the accounting records of budgetary users and those of the State Treasury information system as budgetary users may have different information recorded in their ledgers.

Modernization measures

- **Change the procedure for allotments and reservations** in the State Treasury information system so that they are **not limited by the level of payments planned for the current month**.
- **Implement an automated system of commitment control** (negotiations underway), including multi-year commitments.
- **Introduce, by way of Government regulation, a carry-over procedure for invoices falling due for payment in the subsequent fiscal year.** Carry-over will be possible for capital expenditure and, perhaps, a small percentage of current expenditures. The Minister of Finance will have to be able to set a deadline after which new commitments are not allowed.
- Revise appropriation management rules (e.g. rules for transfer between budget items). In order to improve efficiency in programme management, line ministries should be provided with a modicum of flexibility in budget management. However, measures aimed at providing line ministries with increased flexibility in public expenditure management will be closely coordinated with the actions aimed at reinforcing internal control. Some very detailed controls can be immediately relaxed without inconvenience, e.g. 5% changes between budget lines related to the same type of expenses.
- **Change the way how funds are released** in the State Treasury information system. A move should be made from **current monthly releases to quarterly releases** (i.e. for a three-month period). This should reduce the administrative burden and the need for constant updating of spending limits. For most budget items, the timing of the payment is non-discretionary. This applies to salaries, pensions and other entitlements, as well as most material costs.
- **Review different categories of expenditures and revenues currently managed outside the TSA** in order to:
 - define budget management rules when including these expenditures in the TSA;
 - implement expenditure control system;
 - eliminate loopholes in the expenditure control system.Foreign currency transactions (inflows and outflows) should be included in the TSA.



Steps are to be taken to ensure that all payments are made directly from the TSA into beneficiaries' and suppliers' accounts.

- **Modernize payment and banking procedures.** Introduce e-banking in order to obtain timely information about the status of issued payment requests and account balances.
- **Introduce procedures to centralise data on commitments,** including multi-year commitments.
- **Develop a reporting system to ensure information on cash payments and arrears. Set up automated procedures to compare modified accrual-based accounts with cash-based accounts.**

3.2.2. In-year financial planning

The present state of affairs

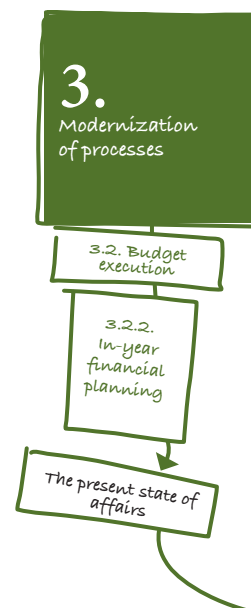
Operational processes and data sources have been established, data access methods developed, procedural steps described, and a reporting system has been defined and elaborated with respect to the planning of financial flows and liquidity forecasts, which are made on a monthly, weekly and daily basis.

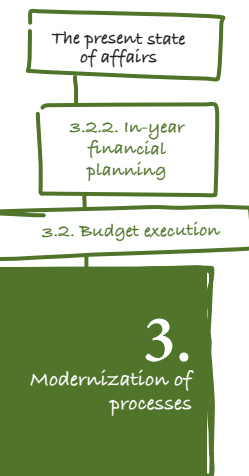
The cash position (both in the national and foreign currencies) is determined on the basis of consolidated account balances. There is on-line access to this data (Single Treasury Account — national currency; budgetary users' accounts with commercial banks — national currency), which is entered into the State Treasury information system by the Financial Agency (FINA), and shows up in the system with a delay of one day.

Data on foreign-exchange balances with the Croatian National Bank and commercial banks is delivered via postal mail or e-mail in the form of bank statements, which are then entered and recorded by the State Accounting Department.

Monthly, weekly and daily revenue projections (structure, size and dynamics) are made by the Macroeconomic Analysis and Planning Bureau of the Ministry of Finance, based on time series analysis and in accordance with the yearly revenue forecast.

Expenditure projections (structure, size and dynamics) are prepared on the basis of budgetary users' cash plans, reservations and payment requests entered in the SAP system (i.e. State Treasury information system). These documents are used to produce data on the level of expenditures, their structure and maturity dates.





Public debt projections are made by the Public Debt Management Sector of the MoF on a monthly, weekly and daily basis. Information on public debt repayment, broken down by the type of expenditure, terms of payment (long-term, short-term) and the amount of principal, interest and guarantee payments, is stored in a separate database within the public debt management information system (TREMA) of the Public Debt Management Sector.

Income projections (structure, size and dynamics) are prepared based on the estimates of anticipated revenues, expenditures, obligations carried over from the previous period and estimated public debt liabilities, including the cash position – balances in the accounts. The estimates for different budget categories are then used to determine the cash deficit/surplus for a given month, week or day. A final decision on the capital market instrument that will be used to cover the deficit (or any part thereof) is taken by the Borrowing Department on the basis of bids from banks and other financial institutions in the money market, calculated cost of borrowing and cost-effectiveness.

Cash management

Efficient management of the total cash potential (cash pool) of the State is one of the key objectives of the State Treasury. In 2005, significant efforts were thus made to enhance cash management functionality through more efficient planning and forecasting of financial flows and liquidity. This allowed for more accurate estimates of cash deficits/surpluses, as an important step towards more efficient budget execution.

An improved auction system for public debt instruments (i.e. Treasury bills and short-term loans) has been implemented as well. Borrowing criteria have also been defined, which has significantly reduced the cost of borrowing (interest rates) for all financing instruments. The treasury deficit is financed on the money market, up to the amount of funds in the Treasury Single Account held with the Croatian National Bank (as prescribed by law).

Scope for development and modernization

1. Collection of data and preparation of cash flow forecasts

The existing State Treasury information system does not offer capabilities for generating liquidity forecasts and cash flow plans, due to a lack of adequate information on budgetary users' expenditures and revenues from taxes and customs duties.

Revenue forecasts are based on historical data (time series) and current economic trends whereas the State Treasury system provides quality daily (i.e. short-term) projections of budgetary expenditure payments. Long-term expenditure forecasts are based on the execution of expenditures in previous periods and do not correspond to the cash plans and reservations entered in the SAP system.

The existence of numerous information systems and separate databases (SAP, TREMA, FINA, Tax Administration, Public Debt, budgetary users' information systems) is a cause of serious difficulties in the preparation of cash flows and liquidity forecasts and reports. In 2005, the first serious steps were taken towards integrating budgetary users' information systems with the SAP system and public debt management system. This work on systems integration will also continue in the years to come.

2. Under-developed management of financial assets

Although financial assets management, i.e. investment of surplus funds from the state budget account, is regulated by the Budget Act (Article 64), this function has not been sufficiently developed. In an effort to remedy the current situation, rules for the investment of surplus cash from the state budget account have been drafted as an elaboration of Article 64 of the Budget Act and talks have been started with the Croatian National Bank. For the time being, short-term cash surpluses are deposited with commercial banks on the best-bid principle.

3. Cash management and foreign exchange

To ensure efficient management of financial flows and optimal planning of deficit-financing activities, it is necessary to consolidate all borrowing, cash management and foreign exchange activities that are currently dispersed across three separate departments, hindering effective communication and blurring the view of the cash management function as a whole.

It is recommended that these activities be transferred under the authority of the Public Debt Management Sector.

Goals:

- *Effective cash pool management.*
- *Process automation and continuous access and use of historical data and data on payables and receivables.*
- *Integration of all activities related to financial flow management (cash management, borrowing, foreign exchange)*

3. Modernization of processes

3.2. Budget
execution

3.2.2. 1m-year
financial
planning

Scope for
development and
modernization



Modernization measures

- **Improve cash-flow planning and forecasting.** An accurate cash flow plan (i.e. cash budget) requires quality information on cash needs. Procedures are to be developed to monitor payment obligations and prepare cash budgets and borrowing plans.
- **Define processes and procedures to facilitate organizational change with respect to cash management and foreign-exchange operations.** Certain activities of the Budget Execution Sector may be transferred to the Public Debt Management Sector to ensure more efficient borrowing and liquidity management operations.
- **Automate T-bill auction system** through the Bloomberg Auction System.
- **Link SAP and TREMA.**

The basic rationale behind good cash management and efficient allocation of public funds is to: minimize the cost of borrowing, maximize return on government investments and ensure smooth and timely execution of the budget. To minimize the cost of government borrowing and maximize return on public resources, it is necessary to consolidate all government funds in one place and keep the cash balance at the lowest sustainable level which will ensure timely execution of the budget without creating arrears.

3.2.2.
In-year
financial
planning

Modernization
measures

3.2.
Budget
execution

3.
Modernization
of processes

3.3. Accounting and reporting

The present state of affairs

The system of budgetary accounting and financial reporting is governed by the Budget Act. The Regulation on Budget Accounting and Chart of Accounts⁸ lays down details with respect to accounting documents, business records, accounting framework, content of the Chart of Accounts and other matters in connection with budgetary accounting.

The form and the content of financial reports, the financial reporting period and deadlines for the submission of reports are laid down in the Rules for Financial Reporting in Budget Accounting⁹.

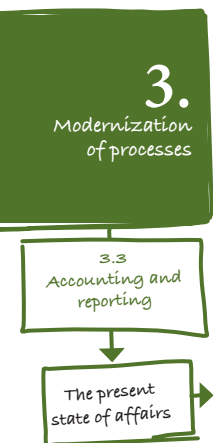
As of 2002, a new concept of budget accounting has been applied. The changes that were introduced into the Croatian budgetary system during 2001 and 2002, effective 1 January 2002, were primarily driven by the need to develop and align the national classification system with international standards and practices and ensure quality information on business operations of individual public entities and the government as a whole, as well as to adapt to global trends and harmonization requirements imposed by major macroeconomic statistical systems (change of the accounting principle). All general government entities now use a single Chart of Accounts based on the economic classification of public revenues and expenditure and a decimal system with five levels of detail.

The new system of budget accounting is based on the modified accrual-based accounting principle, meaning that:

- revenues are recognized in the reporting period in which they are received, provided that they are measurable;
- expenditures are recognized when incurred in the reporting period to which they relate, regardless of whether actually paid;
- depreciation of non-financial long-term assets is not an expense; it is recorded as the adjustment of the value of assets in the balance sheet;
- changes in the value of non-financial assets are not considered expenditure or revenue;
- donations of non-financial assets are not classified as revenues or expenditure.

⁸ : Official Gazette, no. 27/05

⁹ : Official Gazette, no. 27/05 and 2/07.



Budget accounting is based on the generally accepted accounting principles of accuracy, authenticity, reliability and individual presentation of business events (i.e. itemization of inputs), and on the International Public Sector Accounting Standards. A double-entry recording method is used, in accordance with the schedule of accounts in the budget Chart of Accounts. Reporting rules for different groups of accounts in the Chart of Accounts have been defined to ensure that business events are recorded and classified in a consistent and uniform manner.

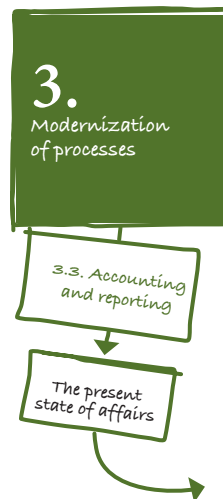
Budgetary users' accounting records are the journal, the general ledger and subsidiary ledgers. Data in the accounting records must be based on authentic, accurate and valid accounting documents. A statement of assets and liabilities as at balance sheet date must also be included.

The Rules for Financial Reporting in Budget Accounting specify, inter alia, the form and content of financial statements and reports, namely: Balance Sheet; Statement on Revenues and Expenditures, Receipts and Outlays; Statement on Expenditures by Function; Cash Flow Statement; Statement on Changes in the Value and Volume of Assets and Liabilities; Liabilities Report. These reports are submitted by the state budget, local and regional government budgets and budgetary and extra-budgetary users listed in the Register of Budgetary Users. The reports and statements are prepared for the periods from 1 January through 31 March, 1 January through 30 June, 1 January through 30 September and for the budget year. Periodic financial reports are kept until the annual financial statement is handed in whereas annual financial statements are stored permanently in their original form.

All financial reports are sent in both hard copy and electronic format to the Financial Agency (FINA), which collects them on behalf of the Ministry of Finance. Financial reports (available via web pages of MoF and FINA) have built-in logical and mathematical controls. Only the reports that satisfy these controls are accepted. The financial reports database (in Access format) is then delivered to the Minister of Finance for his/her use. This control system has been under development since 2002.

The Ministry of Finance issues quarterly instructions for the submission and consolidation of financial statements for the coming period in order to remind budgetary users of their duty and deadlines for the submission of reports, and to draw their attention to any irregularities and errors in filling in paperwork.

In addition to the above, a semi-annual report on budget execution and an annual statement of budget accounts (i.e. statement of accounts) must also be prepared. The semi-annual report on budget execution and the statement of accounts contain:



The present state of affairs

3.3.
Accounting and reporting

3.
Modernization of processes

- summary of total revenues and receipts and expenditures and expenses;
- financing account;
- explanation of the realization of revenues and receipts and expenditures and expenses;
- special part of the budget – a summary of revenues and receipts and expenditures and expenses of the budgetary user;
- explanation of macro-economic indicators and economic and fiscal policies in the budget year;
- report on borrowing and debt management;
- report on the use of budgetary reserves, with an explanation;
- report on guarantees issued in the budget year, with an explanation;
- explanation of programme execution.

The budget classifications which are stipulated for the preparation of the state budget also apply to the preparation of semi-annual and annual statements of budget accounts. The Ministry of Finance prepares the semi-annual report on state budget execution for the first quarter of the current budget year and submits it to the Government by the end of July. The annual statement of budget accounts must be submitted by 1 May of the current year.

Once the annual statement of budget accounts is approved, it is published in the Official Gazette of the Republic of Croatia. The purpose of these semi-annual and annual statements of budget accounts is to produce a comprehensive report on budget execution that will provide a complete picture of public spending in a simple and intelligible manner and thus contribute to overall fiscal transparency.

The Budget Act also provides for the implementation of accountability arrangements by assigning responsibilities for the organisation of budget accounting, its lawful and proper maintenance, validity of accounting documents and the preparation of financial reports.

Line ministries and budgetary users have their own accounting systems and certain ministries are so well linked with their users that they function much like treasuries. So far, no electronic links have been established between the SAP and the financial and accounting systems of line ministries and their users.

Scope for development and modernization

1. Extend the coverage of Treasury General Ledger

Budgetary users must keep their own general ledgers where they record any changes in assets, liabilities, revenues, expenditures, etc. These general ledgers are not interfaced with the General Ledger of the State Treasury so there is no comprehensive data available on the financial position and performance of budgetary users, except the data collected by local treasuries through the system of reservations. Actual financial information is obtained via financial reports.

The Treasury General Ledger does not contain comprehensive data on financial and non-financial assets and liabilities because this data is currently dispersed across a number of different systems. Information on loans and state guarantees is, for instance, kept in the public debt management system (TREMA). There are plans underway to link the TREMA with the SAP system and tie them into the Treasury General Ledger so as to secure complete data on financial assets and liabilities.

2. Consolidate financial statements at the central and general government level

First consolidated financial statements were compiled and presented in 2006, for the preceding year (2005). Consolidation is done manually, using Excel tables that contain summary data from the financial reports of budgetary users and local and regional governments (obtained from the FINA database) and the financial report of the central budget. Since a large number of reports are involved, consolidation is a rather time-consuming process. The first step in the process is the inspection of financial reports and statements in the database. If it is determined that some reports are missing, those who failed to submit their financial statements are then invited to do so. The Budget Act does not impose penalties for missing or late submission of financial statements.

3. Strengthen the implementation of the accounting methodology

The accounting methodology prescribed for the central government and local and regional governments is also used by a wide range of budget entities (courts of law, universities, schools, hospitals, theatres, museums, fire-fighting departments, etc.). To ensure the uniform and consistent application of the methodology, as a necessary precondition for complete and well-prepared financial statements, mandatory continuous training for accounting staff and a sound system of financial internal controls (more on this in Section 3.4 of the Strategy) will have to be implemented.

3. Modernization of processes

3.3. Accounting
and reporting

Scope for
development and
modernization

3. Modernization of processes

3.3. Accounting and reporting


Scope for development and modernization

Goals:

- *Extend coverage of State Treasury General Ledger.*
- *Improve consolidation process at central and general government level.*
- *Introduce system of continuous training and financial internal controls to strengthen application of prescribed accounting methodology.*

Modernization measures

- **Link the information system for public debt management (TREMA) and the financial and accounting system of the State Treasury (SAP)** to ensure comprehensive debt management information in the General Ledger and financial reports. This will improve the quality of the planning process, particularly in the area of interest expenditure planning.
- **Develop a single, comprehensive accounting system** to interface budgetary users' general ledgers with the State Treasury General Ledger. This will allow the central Treasury to obtain data on liabilities incurred and maturity of payments.
- The Ministry of Finance and the Croatian Association of Accountants and Financial Experts are to **continue their programme of education for public sector accountants** that was launched in 2004, with an aim to provide continuous training and development for accounting professionals in the field of budgetary accounting and thus ensure consistent application of the prescribed accounting methodology.
- **Automate the process of consolidation** of financial statements.
- **Introduce penal provisions** in the Budget Act for non-submission or late submission of statutory financial reports and statements.



A single, comprehensive accounting system will facilitate further development of the functions of financial planning and forecasting, anticipation of cash surpluses and shortages and management of cash and debt. Improved management of public finances will also lead to greater complexity of treasury processes and activities, which will require additional knowledge and skills from employees and, consequently, new investments in the development and management of human resources and a clear definition of working processes and procedures.

3. Modernization of processes

3.3. Accounting
and reporting

Modernization
measures

3.4. Development of Public Internal Financial Control (PIFC)

The present state of affairs

The basic prerequisite for quality accounting and management functions is the establishment of a sound control environment and control mechanisms. The basic framework of financial control and management is laid down in the Law on Public Internal Financial Control (hereinafter, the PIFC Law)¹⁰ and consists of a set of inter-related components, namely: control environment, risk management, control activities, information and communication, monitoring and assessment.

To establish a control environment means clearly determining the distribution of rights and responsibilities through task descriptions, operative manuals with defined work procedures and flows of documents/data/information and a «four eyes principle», which practically means that every document should be signed by at least two authorized persons (as defined in the job classification system). An important part of the control framework is internal audit.

The Budget Act defines the basic elements of control environment, as follows:

- Basic budget processes and the course of their implementation.
- Responsibilities and competence of the heads of a budgetary user¹¹ for the lawful, purposeful, efficient and cost-effective use of budgetary funds. The head is responsible for the planning and execution of the budget, assumption of commitments, verification of commitments assumed, issuing orders for payment to be covered by the budget of the entity headed by him/her, establishment of collection rights, and issuing orders for the collection of funds to be credited to the budget. (Article 112)
- Separation of duties between the financial controller, who is responsible for the lawful execution of the principal's (head's) orders in accordance with financial/accounting regulations, and the chief accountant, who is responsible for the lawful and purposeful spending of public moneys for the purposes determined by the budget and financial plan. (Article 113)

¹⁰ : Official Gazette, no. 141/06.

¹¹ : Budget users are, pursuant to Article 3 of the Budget Act, state bodies, local and regional government bodies, institutions, minority councils, budget funds and local governments whose expenditures for employees and/or material expenditures are secured by the budget.

3.
Modernization
of processes

3.4.
Development of
Public Internal
Financial
Control (PIFC)

The present
state of affairs

- Responsibility for the organization of internal audit, as an independent body within the budgetary user, which provides objective assurance regarding the achievement of the budgetary user's goals and objectives, points out irregularities and non-compliance with relevant legal and other regulations, recommends corrective action and measures for the improvement of budgetary user's business operations. (Article 137)

The policy and vision of the Ministry of Finance are laid down in the Strategic Plan for Internal Audit.

In 2006, all existing business processes and stages within the State Treasury were identified and compiled in a list.

At the beginning of 2007, the Ministry of Finance issued the Annual Report on Financial Management and Control, which briefly explains what and how has been done with respect to the organizational structure of the FMC system. The Report also describes ex-ante and ex-post controls performed in the Ministry of Finance.

In July 2007, the Plan for the Establishment and Development of Financial Management and Control System in the State Treasury and the Ministry of Finance was adopted.

The internal audit function for the Treasury is performed by the independent Internal Audit Unit, which was established on 4 April 2005. Every year, based on risk assessment and available resources, the Internal Audit Unit updates the Strategic Plan for the three-year period and the Annual Audit Plan, covering all functions of the State Treasury. Internal audits have already been carried out and recommendations given for further improvement of the State Treasury system of internal controls.

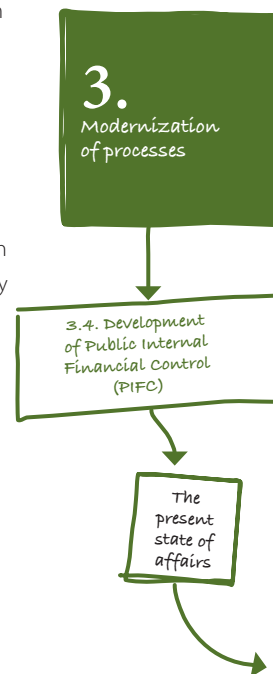
Goals:

- *Develop and implement comprehensive internal control framework in accordance with international practices and legal framework laid down in the Plan for the Establishment and Development of FMC.*
- *Continue work on development and improvement of State Treasury internal audit function.*

Scope for development and modernization

1. Under-developed internal control framework

The internal control framework in the State Treasury needs to be further developed and strengthened in accordance with the internationally accepted COSO model, particularly in the area of control activities (written procedures – audit trail) and risk management, to facilitate accomplishment of the Treasury's mission.



Modernization measures

- Pursuant to the Plan for the Establishment and Development of FMC, which was adopted in July 2007, the following **activities for the establishment of a comprehensive internal control system** are to be implemented: 1. preparation of the State Treasury Policy and Mission Statement; 2. adoption of the plan for the preparation of written procedures; 3. development of audit trails; 4. development of the map of processes; 5. identification of main risks for the purposes of risk management (Risk Registry); 6. development and adoption of the Risk Management Strategy; 7. analysis of the existing/established and expected/needed controls in connection with business processes; 8. preparation of the Plan for the Elimination of Internal Control Weaknesses; 9. progress monitoring and review; 10. preparation of an annual report on FMC; 11. staff training in the area of financial management and control.
- **Continue internal audits on the Treasury systems/business processes** based on identified risks, management needs and requirements and the results of risk assessments conducted in accordance with the methodology provided by the Central Harmonization Unit and CARDS 2004 project (published in the Financial Management and Control Manual).
- **Arrange training and education for all Treasury staff** to enable them to acquire necessary skills and knowledge for the establishment and development of financial management and control. Without proper education, there is a danger that the system development might go off in an unwanted direction. The Minister of Finance and the Head of FMC shall be responsible for staff training and development.

3. Modernization measures

3.4. Development of Public Internal Financial Control (PIFC)

Modernization measures

4. State Treasury information system

The present state of affairs

At the Ministry of Finance (Central Treasury) the SAP R/3 system has been implemented and is currently in operation.

Budgetary users may be classified into two groups, according to the type of accounting and financial IT support they use:

1. Budgetary users that have their own, autonomous and registered Financial Management Integrated Systems (hereinafter, FMIS). The majority of these users are major budgetary users, with over a thousand transactions per year. Only two budgetary users, the Ministry of Health and Social Welfare and the Ministry of Science, Education and Sports, have achieved a certain level of integration between their FMISes and the FMIS of the Ministry of Finance (i.e. the State Treasury). Other budgetary users use SAP consoles to interface with the FMIS of the State Treasury when, for instance, submitting their requests for the payment of invoices received from suppliers. The inevitable delay in reporting/submission of requests is due to manual data entry.
2. Budgetary users that have no FMIS. As their requests for budgetary resources tend to be more modest, they have felt no need to invest in the implementation of accounting IT support. SAP consoles are used to interface and exchange data with the FMIS of the State Treasury.

Due to a great number of implemented FMISes from a variety of manufacturers and with different technological capabilities, every FMIS relies on its own database for storing important business and other data. Currently, only procedures for the inter-organizational exchange between budgetary users and definition of programmes and activities are partly automated. However, the obsolete technological base, need for manual intervention and authorization, lack of technical and other documentation and support, coupled with processing delays, are unacceptable.

Budget preparation and planning are currently supported by the SAP SEM-BW system. Budgetary users enter their plans in the system and make simulations necessary to plan the budget for the following fiscal year.



Strategy for the
Development and
Modernization
of the State
Treasury
2007 - 2011

However, a significant part of budget preparations is still carried out on the basis of unstructured documents, which are entered into the SEM-BW system either manually or following specified automated procedures. Furthermore, some features of the system are ill-suited for budgetary users' needs, e.g. inadequate user interfaces.

Scope for development and modernization

1. Different forms of IT support functioning separately from the State Treasury system

Different budgetary users have different IT systems for accounting and financial management, and the level of overall integration with the State Treasury is relatively low.

2. Double entry of the same data

Accounting data is entered into the FMIS (where implemented) and the SAP so that invoices can be paid by the State Treasury via the Treasury Single Account.

3. Lack of decision-making information

There is no adequate system for tracking funds committed for the procurement of goods and services or payment authorizations for invoices recorded in the information systems of budgetary users. Limited information on invoices and maturity of payments results in inadequate cash management and expenditure forecasts.

4.

State Treasury
information
system

The present
state of affairs

Goals:

- *Integrate State Treasury FMIS and FMISes of budget users.*
- *Improve information support.*
- *Avoid double entry of accounting data.*

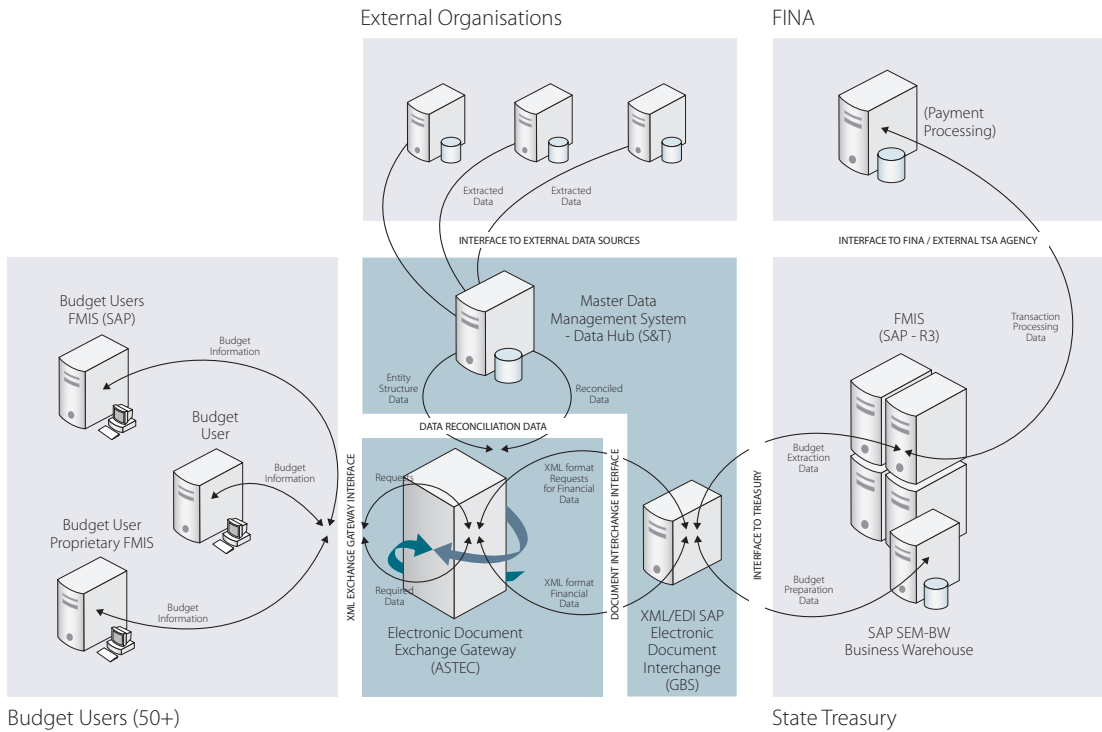
Modernization measures

- **Develop a Master Data Management System** to allow consolidation of master data, as the basis for data exchange between budgetary users' proprietary FMISes and the State Treasury FMIS. The Master Data Management System will facilitate the linking of data and resolution of problems associated with inconsistent master data currently dispersed across different information systems.
- **Set up an Electronic Document Exchange Gateway (EDEG)** between budgetary users' FMISes and the State Treasury FMIS. The Gateway will allow the integration of financial documents recorded in budgetary users' disparate Financial Management Information Systems with the SAP-based FMIS of the State Treasury. This will allow reconciliation of budgetary users' accrual-based accounting data with the cash account of the Treasury information system and thus facilitate the consolidation of the Treasury General Ledger. The Gateway will be used to automatically collect electronic data from budgetary users' financial records and submit it for processing to the FMIS of the State Treasury in order to enable payments to be effected through the Treasury Single Account. EDEG is based on the Interoperability Framework that specifies standards and protocols for electronic data/document exchange based on Extensible Markup Language (XML).
- **Publish a book of standard electronic records, including financial documents, for the exchange between budgetary users and the State Treasury**, concurrently with the implementation of the EDEG. This open specification will enable independent software vendors to offer upgrades for the FMISes used by budgetary users to automatically submit their financial records via the Electronic Document Exchange Gateway to the treasury information system for processing. The EDEG does not specify the type of information support to be used by budgetary users but sets the standard (interchange format) for the electronic transfer of financial documents to the Treasury information system.
- **Expand the existing Document Warehouse** so that the financial documents submitted by budgetary users to the Treasury information system may be collected and grouped to keep track of financial trends (expected revenue, expenditure, projected deficit, etc.), facilitate multi-year budget preparation and simulation of future long-term trends based on key performance indicators for the execution of budgetary programmes, activities and projects. Such a warehouse system will support a multi-dimensional view of the financial data recorded in the State Treasury information system, facilitate performance of necessary analyses and provide reliable and timely information for quality decision-making.

Modernization
measures

4.
State Treasury
information
system

Figure 2.
Integrated system overview



4.
State Treasury
information
system

Modernization
measures

The Electronic Document Exchange Gateway will consolidate all financial data (receivables, payables, revenues, expenditures) in one information system - the State Treasury FMIS. This data will form the basis for the development of financial management and forecasting functions. With the help of reliable and comprehensive financial information, revenue estimates, deficit projections, expenditure management, cash flow planning, cash and debt management will become much more accurate and efficient.

Modernization
measures

4.
State Treasury
information
system

5. Legal framework, organizational issues and change management

The present state of affairs

Legal framework

The legal framework that regulates the area of financial management consists of the Constitution of the Republic of Croatia, the Budget Act and its implementing regulations, the Annual National Budget, rulebooks, instructions and guidelines.

The fundamental act that regulates budgetary processes and relationships between institutions within the Croatian budget system is the Budget Act.

The 1994 Budget Act was superseded in 2003 by the adoption of the new Budget Act, which gives a more detailed definition of: instruments for public expenditure management; planning, preparation, adoption and implementation of the budget; asset and debt management; public debt management; borrowing; state and local government guarantees; budgetary relations in the public sector; accounting; internal control and budgetary supervision.

Although the new Act incorporates modern principles of programme budgeting, international accounting standards and macro-economic stability measures, it is lacking in detail as to how certain provisions could be implemented and in clarity of relationships, rights, responsibilities and functions of different institutions within the budgetary framework (Croatian Parliament, Government, Ministry of Finance and budgetary users).

The new Budget Act provides for the adoption of more than 30 implementing regulations. Most of them are under the competence of the Ministry of Finance, or the Minister of Finance (ordinances), whereas the rest is under the competence of the Government and government agencies (regulations and decisions). Some implementing regulations have not yet been articulated due to unclear and illogical provisions in the Act, which are largely unenforceable in practice.



Strategy
for the
Development
and
Modernization
of the
State Treasury
2007 - 2011

Example:

Article 128 of the Budget Act states that the Ministry of Finance is required to prepare a draft proposal of the consolidated statement of budget accounts and submit it to the Government by 1 May of the current year. According to the definition in Article 3 of the Act, the consolidated budget of the Republic of Croatia includes the consolidated state budget (state budget and financial plans of extra-budgetary users) and consolidated budgets of local and regional governments. However, the deadline for local and regional governments to submit their budget accounts does not arrive until 1 May. It follows that the extremely complex and lengthy process of consolidation between the state budget and local and regional government budgets, performed by the Ministry of Finance, would have to be compressed to a single day, which is impossible of course. And herein lies the contradiction: the Rulebook on the Structure and Preparation of Semi-annual and Annual Budget Accounts, Consolidated State Budget and the Budget of the Republic of Croatia cannot be written to comply with statutory deadlines and a regulation that does not comply with statutory provisions cannot be passed.

The above is just one example that clearly demonstrates the need for changes to be made to the Budget Act. More such provisions, whose practical enforcement is either not possible or ambiguous, could be found in the Act, along with a number of other provisions that need to be either amended, strengthened or broadened in scope.

The Ministry of Finance initiated the procedure of making amendments to the existing Budget Act in early 2006. Around the same time, the first screening list aimed at identifying areas of Croatian legislation that need to be harmonized with the financial regulations of the EU was also compiled.

Amendments to the Budget Act mostly concern Croatia's accession negotiations with the European Union. The negotiations on "Chapter 22: Regional policy and coordination of structural instruments" thus require that a legislative framework, in the form of a medium-term financial strategy adopted by the Croatian Parliament, be set up to allow for multi-year programme budgeting, carry-over of capital projects funds from one year to the next, flexibility in budget execution, distinction between cash appropriations and appropriations for accrual-based expenses, etc.

On the other hand, the development of certain aspects of public expenditure management has gone even further than envisaged in the Budget Act. The Act, for instance, does not contain the budgetary classification by sources of financing, which is a vital tool for establishing links between sources of financing and expenditures.

It is clear from what has been said here that significant amendments to the Budget Act are necessary, including subordinate legislation pertaining to the Act.

5.

Legal framework,
organizational
issues and change
management

The present state
of affairs

Organizational issues

Article 3 of the Budget Act defines the State Treasury as an organizational unit within the Ministry of Finance, which is responsible for carrying out tasks in relation to budget preparation and consolidation, state budget execution, state accounting, cash and public debt management and the management of financial and non-financial assets of the state. The State Treasury consists of a number of sectors and departments, namely: the Budget Preparation Sector, State Budget Execution Sector, Public Debt Management Sector, Systems Development Division, and Budgetary Supervision Department. The basic organization of the Treasury has not changed much over the years, except some minor departmental changes. In 2005, a new department was created for the purposes of National Fund operations – the National Fund Division.


Clearly defined mission and vision statements, strategy, organizational structure and mutual rights and obligations with respect to treasury activities are critical for the work of the State Treasury sectors/departments to be carried out in accordance with the principles of interdepartmental coordination and cooperation. No synergy effects can be achieved without full cooperation and partnership. Otherwise, overall performance will always be limited and lower than expected despite all efforts.

Managing change

Job descriptions and scope of responsibilities have not changed significantly since before the State Treasury was established. The job description and classification scheme views the tasks and activities performed by individual sectors or departments separately and marginalizes their interaction within the framework of the State Treasury. As a result, positions and tasks which are necessary for the functioning of the State Treasury but are not exclusively limited to a particular sector/department are not reflected in the job descriptions (e.g. budgetary analysis, monitoring and analysis of revenues by sources of financing and users, monitoring and analysis of general expenses of the State, etc.)

Apart from the need for better inter-sectoral coordination, more effort should also be made to equip employees with the knowledge and skills required to work on systems development and deal with a variety of challenges posed by different process requirements.

Processes often change without sufficient attention to skills required of employees to keep abreast of the changes.



The present
state of affairs

5.


Legal framework,
organizational
issues and change
management

Generally speaking, education and training of the State Treasury staff is conducted on an ongoing basis (IMF seminars; seminars and workshops organised by the Slovenian Centre of Excellence in Finance; US Treasury seminars, study visits to other countries, etc.) but no position-specific training and development plans have been formulated to meet the requirements of particular work responsibilities. Systematic training attendance records should be maintained and staff development plans formulated in order to establish skills and knowledge required for each position so as to design training programmes that reflect individual abilities and expected levels of performance.

In addition to quality, systematic staff training plans, additional staff will also need to be recruited to get these new development processes off the ground.

*The present
state of affairs*

5.
*Legal framework,
organizational
issues and change
management*



Creating effective, modern budgetary processes and institutions is of great importance to all countries. Key “building blocks” include organic budget laws, accounting systems and classifications, cash management and treasury systems, and financial information networks.

A well-developed, organized and regulated system is essential to:

- facilitate the setting and implementation of fiscal policy goals;
- create a crucial bridge with the policy-making process so that the financial impact of alternative policy options (e.g. major capital investment projects) on the budget and the economy can be measured and compared;
- enable in-year monitoring and control of the budget so that, for example, if public expenditure is higher than forecast, corrective action can be taken;
- support government efforts to build effective defence mechanisms against fraud and corruption, by creating a more transparent, open system that can easily be controlled and audited;
- assist the Government in managing the borrowing and debt of local authorities; and
- achieve standards of budgeting and financial control that are necessary in order to gain accession to the European Union.

5.

Legal framework,
organizational
issues and change
management

The present
state of affairs

Scope for development and modernization

1. Implementing legislation

The Budget Act provides for the adoption of more than 30 implementing regulations, decisions and ordinances. However, only a small number of them have been actually issued so far, which often causes uncertainty and confusion with budgetary users and local and regional governments as to the application of certain provisions of the Act. Since the functioning of budget entities is seriously hindered by this lack of implementing legislation, the Ministry of Finance issues procedural guidelines on specific issues to rectify the situation but these guidelines cannot fully compensate for the gap of missing regulations.

The Budget Act provisions are aimed at achieving three basic objectives of public expenditure management: fiscal discipline, allocation and mobilization of resources, and operational management. Fiscal discipline is important to maintain the lawfulness and accountability of the budget execution process. It ensures that budget execution is consistent with the agreed budget. Efficient resource allocation should ensure timely and smooth budget execution and funding for established priorities. Operational management refers to the efficient and effective use of taxpayers' money, i.e. the capacity to achieve objectives and implement programmes at the lowest cost. The lack of implementing legislation to support the achievement of the basic objectives of the budget system, as defined in the Budget Act, decreases fiscal discipline and undermines resource allocation and operational management.

2. Alignment with the sequence of processes

The execution of certain State Treasury tasks does not align with the process sequence. Certain issues are handled outside of the procedural framework in an effort to speed up response times and problem-solving procedures. And while this may improve the short-term functioning of the system, it obscures the distribution of competences and responsibilities among the staff and sectors/departments, creating confusion in the longer term.

3. Analysis and forecasting techniques

The budget is still input-oriented and budget negotiations are not directed towards outcomes and elimination of unnecessary programmes (activities/projects). Work on the development of data analysis techniques has begun only

5.

Legal framework,
organizational
issues and change
management

Scope for development and
modernization

Goals :

- *Draft amendments to the Budget Act, prepare implementing legislation and procedural guidelines to support modernization measures.*
- *Improve quality of State Treasury organisational structure.*
- *Increase expertise, knowledge and skills of MoF staff and provide training for budgetary users.*
- *Steer Strategy implementation.*

recently and projections are generally prepared on the basis of prior experience rather than actual calculations. Management is short-term oriented and significant events are not anticipated early enough. Sound analysis and forecasting techniques must be put in place to remedy the situation.

4. Training and communication between Ministry of Finance and budgetary users

The method of communication by means of detailed written instructions, briefing and training sessions and progress meetings is found to be extremely efficient in practice. Several projects have been successfully brought to completion in this way: implementation of the Treasury Single Account by closing bank accounts and consolidating them into the TSA; mobilization of new sources of

financing; tracking and monitoring of projects funded from grants, donations and loans deposited in special-purpose accounts. This kind of cooperation between budgetary users and Ministry of Finance allows budgetary users to take an active part in the work of the State Treasury and development of budgetary processes. Users' feedback on the implementation of specific changes and recommendations for improvement will be invaluable if real and meaningful progress is to be made.

Modernization measures

- **Draft amendments to the Budget Act** with input from budgetary users (line ministries and other government entities). All Budget Act provisions related to the preparation and adoption of implementing regulations under the competence of the Ministry of Finance are to be reviewed. New provisions of the Act will support and facilitate the implementation of reform measures and provide the necessary basis for strong fiscal discipline, improved resource allocation and operational management¹².

5.

Legal framework, organizational issues and change management

Scope for development and modernization

- **Effective systems development calls for the establishment of new functions, departments and tasks within the State Treasury with clearly defined roles and responsibilities.** A redefinition, mapping and description of the existing processes, followed by appropriate risk assessment protocols, will also have an effect on the existing organisation of the State Treasury.
- **Organize seminars to raise awareness** of the MoF staff, line ministries and state administration bodies about the importance of the reform process and modernization measures.
The staff has to be informed about planned changes before their implementation starts. In addition, they have to be actively involved with the planning, preparation and development of implementation activities.
- **Prepare a detailed staff training and development plan (for the MoF and budgetary users) in accordance with the goals and objectives of the Strategy and modernization measures.** Training will be provided in the field of budget management, notably: macroeconomic and fiscal forecasting, MTEF (medium-term expenditure framework) preparation, definition and monitoring of programme execution performance indicators, programme and project analysis, cash management and forecasting and budget execution analysis. Continuous training is essential for the State Treasury to be able to understand new concepts and implement changes.
- In view of the complexity of the reform (in terms of time, funding and human resources), highly motivated employees are a must. Staff motivation is a key factor of reform implementation. **A list of employees most closely involved in the implementation of the reform/Strategy is to be prepared, along with appropriate motivational methods and techniques to support their commitment to the reform agenda.**
- **Organize seminars, discussion sessions and presentations for the Members of Parliament on other countries' experiences in the implementation of the public finance management reform.**
- **Establish a public relations policy** and develop public communication methods, modes and techniques.

12 : Operational management refers to the efficient and effective use of taxpayers' money, i.e. the capacity to achieve objectives at the lowest cost through the performance of required activities.

5.

Legal framework,
organizational
issues and change
management

Modernization
measures

6. Conclusion – priorities, time-frame and funding

The public expenditure management reform is a complex process that will require, amongst other, changes in the legislative framework and the strengthening of administrative capacity for their implementation. The implementation of the Strategy will require budget process analysis and streamlining of procedures and decision-making mechanisms within the Ministry of Finance and budgetary users.

*Strategy for the
Development and
Modernization of the
State Treasury
2007 – 2011*

The Strategy envisages a large number of measures so setting a realistic time-frame for their implementation, based on available human and financial resources, is fundamental. In any case, the implementation of a medium-term programme budget and the development of an integrated information system for financial management and accounting will require steady efforts towards gradual implementation of changes over the medium term.



This Strategy brings more than just changes to the way public finances are managed; its implementation will bring new values and modify behaviour patterns to support a more accountable, transparent and performance-oriented public sector.

6.

*Conclusion
- priorities,
time-frame and
funding*

Priorities for 2007:

- Develop administrative capacities for reform implementation.
- Create comprehensive database of all adopted strategies, national programmes and other Government policy documents.
- Draft amendments to Budget Act.
- Modernize payment and banking procedures – introduction of e-banking, stage I.
- Integrate TREMA (information system for public debt management) and SAP (State Treasury financial and accounting system).
- Begin implementation of Establishment and Development Plan for Financial Management and Control.
- Localize public accounting training programme to provide continuous education in this area.
- Prepare list of staff closely involved in reform/Strategy implementation, and their tasks and responsibilities.

Priorities for 2008:

- Develop instructions and forms for strategic planning.
- Select pilot ministries to initiate preparation of strategic plan proposals based on new instructions and forms.
- Educate budgetary users in strategic plan development.
- Establish procedures for preparation of MTBF (medium-term budget framework).
- Begin Financial Strategy development.
- Automate consolidation process.
- Change budget execution procedure: allotments, reservations, release of funds.
- Establish, by way of Government regulation, carry-over procedure for invoices falling due for payment in the following fiscal year.

6.

Conclusion
– priorities,
time-frame and
funding

- Modernize payment and banking procedures – introduction of e-banking, stage II.
- Review categories of expenditures and revenues currently managed outside Treasury Single Account (TSA).
- Strengthen cash-flow planning and forecasting.
- Extend TSA: integrate foreign and national currency operations.
- Continue establishment and development of financial management and control.
- Prepare detailed staff training and development plan (Ministry of Finance and budgetary users) in accordance with Strategy goals and modernization measures.
- Organize seminars, discussion sessions and presentations on other countries' experiences with public finance management reform for Members of Parliament.
- Establish public relations policy.

Priorities for 2009:

- Redefine programmes.
- Define programme monitoring and evaluation (assessment) procedures.
- Define performance indicators for pilot ministries.
- Align organizational classification with legally defined areas of competence.
- Integrate State Treasury FMIS and FMISes of budgetary users. Develop single, comprehensive accounting system to interface budgetary users' general ledgers with State Treasury General Ledger.
- Implement automated system of commitment control (negotiations underway), including multi-year commitments.
- Introduce procedures to centralize data on commitments.
- Revise appropriation management rules.
- Establish new functions, departments and tasks within State Treasury with clearly defined roles and responsibilities.

Priorities for 2010:

- Adopt budget at higher level of Chart of Accounts.
- Continue development and implementation of programme budgeting and performance measures.
- Continue integration of State Treasury FMIS and FMISes of budgetary users.
- Develop reporting system for cash payments and arrears.
- Extend TSA: all payments to be executed directly from TSA into beneficiaries' and suppliers' accounts.

Priorities for 2011:

- Continue development and implementation of programme budgeting and performance measures.
- Develop management functions based on specific skills, analyses and information.

The principal institution responsible for the achievement of these priorities is the Ministry of Finance, with the necessary cooperation and participation of all budgetary users.

The implementation of the Strategy will be funded from several sources. The reform will be mostly financed by PHARE, notably in the following areas:

- creation of MTBF,
- development of budget classifications,
- extension of the TSA coverage,
- cash management improvement,
- definition of procedures for the centralisation and control of users' commitments,
- changes to the procedures for the reallocation of budgetary funds during the course of the fiscal year,
- staff training and development in the Ministry of Finance and budgetary users,
- integration of the State Treasury FMIS and FMISes of budgetary users.

Other measures will be funded from grants/donations and the State Budget.

The implementation of the Strategy shall be supervised by the Minister of Finance and the State Treasurer, who shall appoint a steering committee to oversee the implementation of the Strategy within one month from the adoption of this Strategy by the Croatian Government. The steering committee shall meet every three months to give an account of the implementation of the measures set out in the Strategy. This information is to be compiled and presented by authorized personnel (deputy ministers and heads of departments/sectors) responsible for the particular area.



Ministry of Finance of the Republic of Croatia - State Treasury

The Strategy for the
Development and Modernization
of the State Treasury 2007-2011
was adopted by the
Government of the Republic of Croatia
on October 12, 2007.

IMPRESUM

Publisher **Ministry of Finance of the Republic of Croatia** • Graphic design **Petrak – Žaja studio** •
Printed by **BS tiskara** • Translation **Višnja Kukić** • Published in **300 copies**
ISBN **978-953-6758-67-8** • **Zagreb, 2007**

