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**Croatia: Integration Perspectives and
Synergic Effects of European
Transformation in the Countries
Targeted by EU Enlargement and
Neighbourhood Policies Economy**

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Integration Perspectives and Synergic Effects of European Transformation in the Countries Targeted by EU Enlargement and Neighbourhood Policies

Croatia

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CROATIA

INTEGRATION PERSPECTIVES AND SYNERGIC EFFECTS OF EUROPEAN TRANSFORMATION

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*„Integration Perspectives and Synergic Effects of European Transformation in
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CHAPTER 1 - THE POLITICAL TRANSFORMATION PROCESS IN CROATIA

*Study prepared by the
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Introduction

The desire to become a part of the European club has been undoubtedly a crucial motor of the political changes in Croatia. As in any other former communist country, the EC (today's EU) was regarded as a model of economic prosperity, political stability and cultural diversity that the country should become part of. It was generally represented as exactly the opposite of the model that the country had experienced during more than half a century of communist rule.

Furthermore, unlike in the ex-communist countries that were never a part of a multinational socialist federation, this goal was always deeply interlinked with the major desire of the Croatian nation to exercise its right for self-determination and to form an independent national state. Thus, symbolically, to become a member of the European club implied becoming independent, and therefore, the idea of Europeanism gained an even larger amount of support than it was rational to expect in the turbulent last decade in Croatia.

Having said that, one should not forget to mention at least two reasons why the European concept might not have been so popular in Croatia as it was in other post-communist countries:

- The clear lack of capability on the European side to deal with the armed conflict on the Croatian territory, which included the mass deportations of Croatian citizens and the destruction of housing and the economic infrastructure, and which had a direct reflection on the EC's (or the EU's) popularity in the country,
- The negative impact of the aforementioned state-building environment on the nature of the political system and the political culture in Croatia during the 1990s, which appeared to be in contradiction with the basic principles of European integration.

Even after the achievement of independence and international recognition, which were recently marked as directly linked with the essence of the 'pro-European' public opinion in the early 1990s, one may say that the popularity of the European concept was quite high in the late 1990s as well, despite the above-mentioned reasons that may make suggest otherwise. However, the logic behind this fact was mainly linked to the negative attitude towards the regional concept of the Western Balkans, which was introduced by the international community, and in that sense 'being European' meant to be a proof of not being a part of an undesirable framework that has rather negative political connotations.

A significant number of Croatian authors, especially during the 1990s, were actively trying to prove that Croatia was never part of the region called Western Balkans, in which it

had been cemented owing to some world powers' political will, whose main goal was to endanger the young Croatian democracy and sovereignty and to revitalize some form of a new/old Balkan federation. Generally, these interpretations tend to rely on some historical facts, insisting that Croatia was always part of Central Europe, as it had been a part of the Habsburg Empire and a sort of bastion of Christianity, who had long defended Western Europe from the Ottoman invasions and the spread of Islam.

On the other hand, there are many (generally from outside the region, but also some from inside it) who do not see beyond the regional concept. Their oversimplifications make them try to directly apply some mechanisms for regional co-operation that were functional in other parts of Europe. While there are obvious differences between the regions concerned, in particular the inter-relations within them, and especially the incomparable starting points of the so-called Western Balkan countries in the very beginning of their transition and European integration processes.

In general, it is obvious that the perception of 'being European' was not very clear in the country during the 1990s, either for the public, or for the political elites. All this was accompanied by misuses of this concept for political purposes, which represents one of the major reasons for such a delayed start of the 'real transition' in the country.

Namely, the real transition in Croatia, like that in a number of other countries from the region started in 1999, followed by paramount democratic changes and the introduction of the first consistent policy of the EU towards the region – The Stabilisation and Association Process (SAP). The SAP represents a milestone in the relations between the EU and the region, and with Croatia specifically, mainly owing to the fact that it happened for the first time in modern history that the possibility of a full EU membership for the countries of the region was clearly confirmed. This was a major precondition for the EU conditionality to work for the EU side, and even more, it was essential for transitional enthusiasm and a pro-European attitude in the countries of the region and in Croatia in particular. Also, one should not forget another aspect of the new EU policy towards the region that was of utmost importance, especially for Croatia as the most developed country, the so-called own merits policy, which guaranteed the individual assessment of each country in its reform progress and path towards a full-fledged EU membership.

The previous vague framework that had caused so many suspicions was finally enriched with some new elements, which gave new energy to the country's reform process. This was another confirmation of the fact that the EU membership perspective boosts the 'transitional enthusiasm' of a country and a nice example how it opens a manoeuvring space

for the EU to use the conditionality mechanism as a reliable corrective in the process. Although the SAP concentrated on stabilisation and other post-conflict problems rather than on the accession process to the EU, it proved useful as a stimulating framework for changes, owing to the fact that it showed 'some light at the end of a tunnel' and managed to contain a satisfactory level of bilateralism within its regional concept, and hence, it allowed the country to remove its own obstacles on the way to the EU membership, without being burdened by 'somebody else's problems'. On the other hand, it helped the EU much in its attempts to regain credibility after years of a lack of a clear position, not to mention a coherent policy. It also shook up the Croatian state administration, which had been immobile for years, by the creation of the new Ministry of European Integration. Although this institution encountered some difficulties, it performed really well in mobilising the rest of the apparatus, as well as society in general.

From that time on, the country has been experiencing a totally different dynamics in the reforms process and its relations with the EU, which has been followed by the change of the perception of the EU in both the public and the political elites. The discourse of the debate on the pros and cons for joining the EU have become dominated by pragmatic issues and clear arguments.

Therefore, it is obvious that one can differentiate between two periods of recent Croatian history, which have almost opposite attitudes towards the meaning of 'the European concept'. The changes that happened during the turn of the century clearly show the importance of the new framework of relations between the EU and the countries from the region, which has positively affected the political development in Croatia in particular. The perspective of the EU membership was a crucial motor that helped the country pass through its 'democratic catharsis' and reach standards of democratic development that had been almost unthinkable less than ten years ago. In the present final phase of the EU integration process, it made it possible to achieve some very painful compromises that were required for the successful continuation of the process. In that sense, it is important to mention that even the greatest Euro-sceptics, who are mainly marginalised in Croatia's political life, cannot afford to question the general necessity for the country to join the EU.

1.1 The creation of democratic institutions and their functioning

1.1.1 Difficult path towards independence and democratic state-building

In order to understand the current developments as well as the ones that this paper will try to predict, it is worthwhile to turn to the past and glance at the way former Yugoslavia dissolved and Croatia gained its independence and sovereignty. Having in mind the size limitations of this research, this part will briefly analyze the period after the fall of the Berlin Wall, despite the fact that the roots of the whole process can be found in earlier periods.

After Tito's¹ death, whose political figure and personality generally represented the integrative factor for the preservation of the 'Fraternity and Unity myth', the differences between the republics with regard to the constitutional arrangement and the future of the federation started to show up. The internal tensions that broke up the Communist Party of Yugoslavia, and which reflected the general shape of the country that had started falling apart a long time before that, prompted the authorities of the federal republics to call for the first free multiparty election in more than fifty years, which marked the beginning of the end of the federation. On the other hand, the geostrategic importance of Yugoslavia dramatically declined with the collapse of the bipolar system of international relations², which gave the nationalist power the opportunity to take part in the process of dissolution.

As a result, the war broke out, determining the end of the political stability that had been preserved by the two big global poles from the outside and by the military and police repression from within. The fighting continued to spread rapidly, mainly owing to the procedural vacuum in the relations between the leading European countries that emerged after the end of the Cold War. Taking everything into consideration, it was clear that there was no adequate political structure in Europe after the Cold War which would be able to cope with the situation³.

¹ Josip Broz Tito – President of the Socialist Federal Republic of Yugoslavia, died in 1980.

² During the Cold War, the wider region was characterised by the strategic balance formula 2+2+2 (two NATO members – Greece and Turkey; two Warsaw Pact members – Bulgaria and Romania, and two countries outside the bloc frameworks – non-aligned Yugoslavia and isolated Albania).

³ The EU, which acted without clear political will, was prepared to offer only humanitarian aid, which prolonged the *status quo*. – See details in Sandro Knezovic, "The Western Balkans Security Dysfunctions and the EU Response: From Pacification To Integration", *Croatian International Relations Review (CIRR)* Vol. 10, No. 36/37 (2004).

The so-called Antibureaucratic revolution⁴ that had started from Belgrade with the political upsurge of Slobodan Milosevic resulted in the abolition of the autonomy of two provinces (Kosovo and Vojvodina) and the assurance of Milosevic's absolute political domination among the Montenegrin political elites. Having achieved this, he managed to completely block the decision-making process in the highest executive body of the dissolving federation (the Federal Executive Council) and to put additional pressure on the other republics (especially Slovenia and Croatia) that were opposing his unitary concept of Yugoslavia and opting in favour of the more loose confederative model. Apart from this, he succeeded in recruiting the Serbian population in Croatia as well as in Bosnia and Herzegovina to support his political agenda of redrawing Serbia's boundaries to include the territories of other republics where Serbs were living, in case of the dissolution of Yugoslavia⁵. By means of a strong nationalist propaganda and the transfer of troops, weapons, as well as significant financial support, he managed to *light the fire* of a rebellion, which resulted in the occupation of more than 30% of the Croatian territory.

Hence, it is obvious that unlike most ex-socialist states that have found the opportunity to change their societal, political and economic system and start on their path towards the European club in the historical year of 1989, Croatia unfortunately had to take a different, much more difficult road to get to where it is now. It was forced to fight a war for its independence, a significant part of its territory was occupied for almost four years, communication between its continental and coastal part was almost made impossible, and any kind of development was blocked.

During the war in Croatia, more than 13,000 people were killed, 2,300 are still missing, 40,000 were wounded, and the first estimations of the nominal damage of the war were approximately USD 20 billion (EUR 15 billion). Of course, the real damage is much more serious and still difficult to capture, since a significant part of the country's housing, economic and transport infrastructure was destroyed. Also, there is still a large number of

⁴ The term 'Antibureaucratic revolution' is used for the political praxis of the Serbian political elites in the late 1980s. In that period of crisis in former Yugoslavia, instead of the 'working class', the ethnically defined nation was inaugurated as the 'motor of changes' and the leadership of one republic 'showed the ambition to solve the problems' of a non-functioning state. The changes that were about to take place were to affect 'the bureaucracy', i.e. anybody who opposed the new leadership and the changes that it offered (the abolition of Vojvodina and Kosovo's autonomy, the unification of the federation, etc.).

⁵ It is quite illustrative to recall his famous idea of all Serbs living in the same state, whatever it takes to achieve it - "We believe that Serbs have the legitimate right to live in one country. If we must fight, then by God, we will fight." Milosevic's Yugoslavia, http://news.bbc.co.uk/hi/english/static/in_depth/Europe/2000/milosevic_yugoslavia/croatia.stm.

land-mines⁶ that take the lives of Croatian citizens, which directly affects free movement within some remote and rural parts of the country and has a negative effect on the development of the agriculture and livestock farming, which represented a significant part of the Croatian GDP in the pre-war times, especially in the regions that were severely damaged during the war (Slavonia and Lika), which are still facing serious difficulties in recovering from it.

Therefore, although Croatia was economically and structurally the most developed one among the ex-socialist countries, apart from Slovenia, instead of having the possibility to use this position to advance further and to start its process of accession to the EU (the EC at that time) and NATO, Croatia was forced to cope with the above-mentioned situation of being a war-torn country, and fight for the recognition of its sovereignty in the international arena. Both efforts were more than demanding, since Croatia was under the weapon imports embargo and faced a force that was surpassingly stronger, better equipped and supported by the local population (i.e. the ex-JNA and various Serb paramilitary forces), as well as the international community, which seemed, at least from the Croatian point of view, 'to have difficulties comprehending' what was actually going on in ex-Yugoslavia, and it was trying to preserve it even though it had obviously not been functioning for a significant period of time.⁷

On the other hand, the development of the internal political life was not helpful either in the country's progress in terms of the development of democracy and the rule of law, not to mention meeting some of the crucial criteria required for the accession to the Euro-Atlantic community, which a number of ex-socialist countries had started to tackle. The first multi-party election brought the HDZ (*Hrvatska demokratska zajednica* – Croatian Democratic Union) to power under the leadership of the ex-communist dissident and nationalist historian Franjo Tuđman, who was elected president.⁸

It is important to notice the fact that the HDZ was a movement rather than a party, which was organised with one very clear goal – Croatian independence - and which had under its umbrella assorted groups of liberals, modernisers, as well as ex-communists and

⁶ Still today, 12 out of the 21 Croatian counties are not totally mine-cleansed. Between the years 1998 and 2007, 273 persons were victims of mines (101 dead), and the estimations of the Croatian Demining Centre show that there are still 240,000 mines hidden in 1044 km² of mine-suspicious area within the country. Website of Croatian Demining Centre, <http://www.hcr.hr/index.php?link=faq&lang=hr>.

⁷ An excellent example for this is a statement of former French President Mitterrand on the eve of the dissolution of the former Yugoslavia, according to which there is no reason to support the dissolution of some European countries, while the rest of Europe is in the middle of the process of unification.

⁸ See details on this in the next section.

right-wingers, who shared the same idea of a Croatian statehood. Of course, during their struggle for independence or just for changing the old communist regime, other countries have had the same experience – for example, Slovenia with *DEMOS*, and Poland with *Solidarnosc*.

However, the crucial difference between these countries and Croatia, apart from the important fact that only Croatia was forced to fight a long and devastating war for its independence⁹, is that the Croatian movement of HDZ, unlike the ones in other countries, did not disappear from the political scene or split up into several parties after fulfilling its main cause, but it remained in power by means of mechanisms characteristic of semi-authoritarian regimes, showing very modest efforts to become ‘one of the subjects of Western-like political life’ in the country.

Therefore, unlike during the first period of the transition, in the mid-1990s Croatia became more frequently regarded as a part of the backward South Eastern region rather than a part of the Central-European group of advanced transition countries. The initial attitude towards the country was directly related to the assessment of its transformational capacities, such as the type of the former communist regime (which was rather open compared to other ex-socialist countries), its political, religious and cultural tradition (mainly in reference to its history within the Habsburg Empire), and the level of its economic development (which was far better than the average in the other ex-communist states at that time).

As it was identified by Kasapovic¹⁰, this sort of change in the perception of the potentials of the Croatian transition happened owing mainly to two important factors: the war and the low quality of the transformations process. The war made the transitional processes (i.e. the transformation of the society, and the economic and political system in the country) of secondary importance, owing to the fact that the defence of a new-born state against the aggression and secession of its parts was given top priority. It is not difficult to find theoretical confirmation to the argument that it is highly unreasonable to expect from a country to start dealing with problems of political transformation unless it has resolved its main issues of existence. Even more, that can be regarded as an issue of general consent among experts dealing with democratic consolidation world-wide, not to mention the absolute incompatibility of war with the processes of democratic consolidation.

⁹ Having said that, the author does not want to underestimate the importance of the Slovenian war for independence but only underlines the fact that fortunately it was not devastating and long, and it did not have as strong a negative impact on the country’s economic and political life.

¹⁰ Mirjana Kasapovic, *Hrvatska politika 1990-2000*, (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2001).

In Croatia, the war and the occupation dramatically endangered the territorial integrity of the country, and hence, any kind of democratic consolidation. After the international recognition of Croatia's independence and sovereignty, the state borders were formally confirmed, but they were not entirely controlled by the country's authorities until the peaceful reintegration of Eastern Slavonia was finalised in 1998. The Croatian democratic consolidation was affected by the war in Bosnia and Herzegovina¹¹ as well, owing to the fact that the development on the ground led to the creation of parallel Croatian authorities, which were loyal to the government in Zagreb, which, in turn, owing to the fact that the territorial integrity of BiH at that time was rather questionable, kept the issue of Croatia's Eastern borders open due to secessionist aspirations on its side.

In general, the democratic transition in Croatia in the 1990s was conducted in a very turbulent environment, both in terms of the development in the country and in the region, and it was marked mainly by war, destruction and the violation of various kinds of rights that are in the developed democratic world. Starting with a short war in Slovenia, the Homeland war in Croatia, the long and devastating war in BiH, and ending with the ethnic cleansing in Kosovo and the NATO military intervention against Milosevic's regime in the former Federal Republic of Yugoslavia, the 1990s in this region will surely not be remembered as the typical initial period of the post-socialist democratic transformation like the ones in the countries of Central and Eastern Europe, which have successfully finalised their transition process and are already members of the Euro-Atlantic community. Therefore, as it was emphasized in the introduction, one may conclude, that the real process of democratic transition in the region and in Croatia started with 'a decade of delay', and especially for the purpose of this research, this fact has to be taken into consideration with special attention.

1.1.2 The Croatian democratic tradition and the post-communist political transition

One of the most frequently used arguments in the Croatian political life during the last two decades when speaking about the right for self-determination and statehood in the early 1990s or about 'Croatia's deserved place in the eastern democratic world' is without any doubt that of the tradition. It is enough to take a look at the preamble of the Croatian constitution in order to understand the importance of this argument in the political discourse:

¹¹Hereinafter referred to as 'BiH'.

“The millenary identity of the Croatia nation and the continuity of its statehood, confirmed by the course of its entire historical experience within different forms of states and by the preservation and growth of the idea of a national state, founded on the historical right of the Croatian nation to full sovereignty, manifested in:

- the formation of Croatian principalities in the seventh century;
- the independent mediaeval state of Croatia founded in the ninth century;
- the Kingdom of Croats established in the tenth century;
- the preservation of the identity of the Croatian state in the Croatian-Hungarian personal union;
- the independent and sovereign decision of the Croatian Parliament (*Sabor*) of 1527 to elect a king from the Habsburg dynasty;
- the independent and sovereign decision of the Croatian Parliament of the Pragmatic Sanction of 1712;
- the conclusions of the Croatian Parliament of 1848 regarding the restoration of the Triune Kingdom of Croatia under the authority of the Banus grounded on the historical, national and natural right of the Croatian nation;
- the Croatian-Hungarian Compromise of 1868 on the relations between the Kingdom of Dalmatia, Croatia and Slavonia and the Kingdom of Hungary, grounded on the legal traditions of both states and the Pragmatic Sanction of 1712;
- the decision of the Croatian Parliament of 29 October 1918 to dissolve state relations between Croatia and Austria-Hungary and the simultaneous affiliation of independent Croatia, invoking its historical and natural right as a nation, with the state of Slovenes, Croats and Serbs, proclaimed on the former territory of the Habsburg Monarchy;
- the fact that the Croatian Parliament had never sanctioned the decision of the National Council of the State of Slovenes, Croats and Serbs to unite with Serbia and Montenegro in the Kingdom of Serbs, Croats and Slovenes (1 December 1918), subsequently (3 October 1929) proclaimed the Kingdom of Yugoslavia;
- the establishment of the Home Rule (*Banovina*) of Croatia in 1939, by which Croatian state identity was restored within the Kingdom of Yugoslavia,
- establishing the foundations of state sovereignty during the course of the Second World War, by the decisions of the Antifascist Council of National Liberation of Croatia (1943), as opposed to the proclamation of the Independent State of Croatia (1941), and subsequently in the Constitution of the People's Republic of Croatia (1947) and all later constitutions of the Socialist Republic of Croatia (1963-90), on the threshold of the historical changes, marked by the collapse of the communist system and changes in the European international order, the Croatian nation by its freely expressed will at the first democratic elections (1990) reaffirmed its millenary statehood. By the new Constitution of the Republic of Croatia (1990) and the victory in the Homeland War (1991-95), the Croatian nation demonstrated its will and determination to establish and defend the Republic of Croatia as a free, independent, sovereign and democratic state.

Considering the presented historical facts and universally accepted principles of the modern world, as well as the inalienable and indivisible, non-transferable and non-exhaustible right of the Croatian nation to self-determination and state sovereignty, including its fully maintained right to secession and association, as basic

provisions for peace and stability of the international order, the Republic of Croatia is established as the national state of the Croatian nation and the state of the members of autochthonous national minorities...”¹²

Despite the fact that similar formulations may be seen in the preambles of other constitutions as well, the way these arguments have been used recently underlines their specific importance for the legitimation of the main goals of the national policy, both in the country and abroad. While it is obvious that the specific importance of the tradition argument shall not be underestimated in the analysis of the Croatian political transformation process, we may still find different interpretations of its motivation of use, especially in the 1990s. One of them relies on a legitimate right of the nation to recall its historical tradition in the process of national state-building, which is a typical example how nations faced with a deficit of the ‘modern legitimacy elements’ tend to rely on those from past centuries, marking their transition with traditionalist and backward-oriented characteristics, which directly affect the success of the whole process, which is conducted in a world dominated by globalisation.

Regardless of the interpretation one may choose, it is undeniable that there is a tradition of Croatian sovereignty through the centuries in different forms and environments. However, one still has to see if this means that there is a democratic tradition in the country that may affect the contemporary post-communist political life, and if it can have any influence on the pace of the transition process.

The analysis of the Croatian political life in the last two centuries brings us to the conclusion that there is only a modest democratic tradition, with very limited impact on the contemporary political life, especially bearing in mind the fact that the experience of a liberal civic political practice in the late 19th and early 20th centuries has been overshadowed by the negative consequences of the various types of dictatorships in the 20th century. As Zakosek¹³ clearly states, in the period of the initiation of the Croatian civic political practice within the Habsburg Empire (1848 – 1918), owing to the limited and uneven voting rights, there were no conditions present for the development of a broader political participation, and the parliament had only limited influence on the government’s policies.

However, one may argue that in the period after 1861, i.e. after the reestablishment of the constitutional order in the empire, the conditions were set for the articulation of different

¹² Constitution of the Republic of Croatia, Preamble – Official Web-Site of the Constitutional Court of the Republic of Croatia, http://www.usud.hr/default.aspx?Show=ustav_republike_hrvatske&m1=27&m2=50&Lang=en.

¹³ Nenad Zakosek, *Politički sustav Hrvatske* (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2002).

political options and preferences, as well as for the formation of the first modern parties. While only the educated elites participated in the process in the very beginning, the middle and low class citizens, as well as the workers and peasants started taking part in it in the late 19th century.

Between the years 1918 and 1929, in the newly formed Yugoslav state (the Kingdom of Serbs, Croats and Slovenes) there was a short period of very limited democratic parliamentarianism, which had a rather negative impact on the Croatian political life. First of all, the former members of the Habsburg Empire gathered in the State of Serbs, Croats and Slovenes were unlawfully drawn into a common state with Serbia and Montenegro, which was called the Kingdom of Serbs, Croats and Slovenes, by an unilateral decision of the Serbian Regent Alexander (December 1918). In contrast with the political position of the State of Serbs, Croats and Slovenes, which demanded negotiations on an equal footing, the aforementioned state was attached to the Serbian state, and accordingly, completely centralised.

Having lost its own parliament, the Croatian political participation was limited to the right to select the representatives for the Yugoslav parliament in Belgrade. Political life in general was marked by the constant struggle between the Serbian centralists and the autonomists from Croatia and Slovenia, the intensity of which frequently challenged the sustainability of the political institutions. The tension reached its peak in 1928, with the assassination of a group of leading Croatian politicians in the parliament in Belgrade by a Serbian deputy, which resulted in the boycott of the common political institutions by the Croatian parties. This was used as a pretext for the introduction of the king's dictatorship in 1929, i.e. absolute centralisation marked by the suppression of any aspect of democratic life in the country. Even after the reintroduction of some 'constitutional institutions' in the early 1930s, it was obvious that even the minimal preconditions for the development of a democratic environment were missing, and given the fact that the situation did not change substantially until the beginning of the Second World War, it is clear that there was no form of democratic tradition whatsoever before the Second World War.

The antifascist partisan movement in the Second World War, which was based on the communist doctrine and was led by Josip Broz Tito, developed to a recognisable political force only in the early post-war period, and it played a decisive role in the formation of the socialist Yugoslav federation. Despite the fact that Croatia as a constitutive republic in the former Yugoslavia had its own political institutions, open communist dictatorship was immediately introduced in late 1945, so there was practically no chance for the development

of any kind of basis for a democratic political life in the post-war period. A whole set of problematic relations in this most complicated and conflict oriented country in this part of world was planned to be solved by implementing the Soviet model of communism without any critical assessment of the system, which was believed to be universally applicable. With that concept, after taking the absolute power in 1945, the Yugoslav Communist party started the elimination of basic values of the civic society such as the multi-party system, private property, free market, civil rights, religious rights, national traditions. Despite the fact that the Stalin-Tito conflict in the late 1940s provoked the rejection of the Soviet model and brought some visible changes into the Yugoslav political system, substantial democratic changes did not occur, and the hegemony of only one party remained intact.

Therefore, in the period between 1918 and 1990, Croatia found itself in the framework of the Yugoslav state, which represented the outcome of the dissolution of the Austro-Hungarian Monarchy and the dictates of the First World War winners, i.e. the creation of the so-called Versailles world order. It was expected from the creators of this world order that Yugoslavia, as a unified country, will ensure peace or at least a power balance in a traditionally troublesome region, where the First World War had been initiated. During the more than seventy years of the existence of the Yugoslav political project, various types of state organisation, governments and political systems were put in place and different forms of constitutions have appeared during that time as well.

However, the essence of all these regimes was basically the same – autocracy and dictatorship. Despite the fact that they were marked by various ideological and political fore-signs, all of them were based on principles directly opposing democracy and the rule of law, with evident lack of respect for human rights, the rights of minorities and individuals. This state, which was formed based on different political traditions, cultures and religions, tried to legitimize itself within its borders and abroad by, for example, investing into efforts to invent a unique Yugoslav nation or an atypical form of socialism called socialist self-management. However, since the existence of the country was ensured mainly by force – of the two global blocks during the Cold War from the outside and the repressive apparatus, i.e. the army, police and secret services, from within – it was inevitable that the collapse of communism would have an enormous impact on the political map of this part of Europe as well.

Taking into consideration the basic determinants of the Croatian political life in the presented period, one can conclude that it is very difficult to find a recognisable democratic tradition that may have affected the contemporary political life in the process of the post-

communist transition, and perhaps it would not be incorrect to conclude that the era of free and democratic elections started only after the fall of the communist regime.¹⁴

1.1.2.1 The first free multi-party elections (1990)

Formally, the first Croatian elections that can be regarded as free were conducted in 1990, while Croatia was still a part of the Yugoslav federation. According to a number of authors, these elections cannot be seen as constitutive elections, but rather as pre-constitutive ones. However, one may view this opinion with reservations, given the fact that according to the legislation in power at that time, the level of the republics as constitutive elements of the federation was the highest level for the elections to be conducted. Namely, according to the 1974 constitution, the institutions of the federation were constituted only as the representative bodies of the republics, while they preserved the exclusive right to delegate their representatives. Hence, in the existing Yugoslav constitutional framework there could not have been any form of elections conducted at the federal level.

As a consequence of the inability to reach any kind of compromise at the federal level regarding the course of political and economic reforms, and the awareness that the transformation towards democracy and a market economy in the existing federal framework was highly unlikely to happen, the ideas favouring the conduct of free multi-party elections started to be more frequently advocated in the two North Western republics (Slovenia and Croatia). During 1989, the first political organisations emerged in Croatia as the core of the future formation of different parties and started arguing for the defence of the Croatian sovereignty, for conducting the first free elections, and the introduction of a multi-party democratic system. The reform-oriented forces started to grow stronger in the society, which directly affected the Communist Party as well, and thus, it was of crucial importance for the further developments in the Croatian political transformation.

The decision on the conduct of free multi-party elections was made in December 1989, in a very complex interaction of the party in power and the new opposition movements and parties, marked by mass public demonstrations, different petitions in support of the demands of the representatives of the opposition that were forwarded to the parliament and other state bodies. In this context, one should not underestimate the importance of the

¹⁴ As it was stated in the introduction, reservation shall be kept regarding the exercise of 'real democracy' in practice as we understand it today in the period before 2000. However, regardless of that, the fall of the communist regime had significant importance in the political life of Croatia, and therefore, we are here referring to that period.

international developments – the fall of the communist regime in Europe, and the violent break-up of the Ceausescu regime in Romania. While these developments undoubtedly influenced the decision to conduct free multi-party elections, the crucial motivation that helped overcoming political differences within Croatia and coming up with this sort of step in the process of the initiation of the transition was a need to form an apparatus capable of ensuring the defence of the country from brutal aggression and that could ensure the basic elements for the creation of a new sovereign state. In line with that, in a very short period of time, the changes of the constitution were adopted, along with the first draft of the election legislation, as well as a number of other legislations necessary for the conduct of the first free multi-party elections. Of course, the electoral law was of utmost importance, bearing in mind the fact that it determined the rules of candidacy, the protection of electoral rights, and the procedures of the determination of the election results.

The institutional framework of the parliamentary elections at that time may be regarded as a result of the transformational pattern of the transition in Croatia, where the reformed communists had a decisive influence on the crucial conceptual choices, while the specific conditions of the transitional process in the neighbourhood also affected its form and outcome. Owing to a very late emergence of the political opposition in the form of political organisations or parties, and the significant weaknesses of the democratic movement in general, combined with severe pressures from the Serbian national movement, the communist party took on the responsibility to define the conditions for the legalisation of political pluralism, to conduct the constitutional reforms, and to decide on the date of the elections.

A majority electoral system was established in Croatia, which contained the use of the principle of an absolute majority and two-round elections. The basis for the establishment of such a system was the French electoral system from the year 1986, which, apart from the above-mentioned, included the following: uninominal election counties and a threshold of 7% for participation in the second round of the elections, as well as the methodology of the division of the state into electoral counties, which drastically affects the outcome of the elections.

It was obvious that the elections were seen as a precondition of the general political reconstruction, and therefore, one can conclude that they were treated mainly as an instrument in that process. This shows that the so-called functional interpretation of democracy prevailed. In that sense, the majority elections were regarded almost as a necessary precondition for the creation of a democratic system, and, taking into consideration the fact that the number of different minor parties was growing, and they were producing

large polarisation, a guarantee for the concentration of the political spectrum required the creation of a sustainable government. According to that interpretation, proportional representation could have had a negative impact on the atomisation of the political life, and hence, on the stability of the political system, especially in the turbulent environment in which it was created.

The political interests of the particular parties, related to their expectations in terms of the electoral process, which significantly influenced the choice of the model of the electoral system. The Communist Party in power (SKH – SDP) advocated for the majority system, owing to the fact that at that time it had a developed organisational structure with solid financial support and connections with the population. Given the fact that this type of electoral system favours big parties while discriminating against the small ones, from their position it was reasonable to expect that the outcome of the elections organised in such a way would be favourable for them.

The second big party (HDZ – *Hrvatska demokratska zajednica*, Croatian Democratic Union) managed to gain a significant support of the population and significant financial support from the Croatian diaspora, and hence, to take advantage of the majority elections and take the power. The remaining small parties, which had limited influence, objected to the electoral system, mainly because of the fact that it left very limited manoeuvring space for them in the political arena, which was clearly visible from the elections results.

The D’Hont method of vote counting also contributed to the final outcome of the elections, distorting the results and creating a so-called artificial majority in the parliament. The next table shows the disparities between ‘the values’ of the votes of the different parties:

Table 1.1 The average number of votes for one mandate in the first round of the parliamentary elections in 1990

PARTY / COALITION	AVERAGE NUMBER OF VOTES FOR ONE MANDATE IN THE FIRST ROUND
HDZ	22,090
SDP	50,637
KNS	143,189
SDS	46,418
Independent	118,167

Source: Mirjana Kasapovic, *Izborni i stranacki sustav Republike Hrvatske* (Zagreb: Alinea, 1993): 45.

This shows that the electoral system had a crucial role in determining the elections results and thanks to the majority system, the absolute majority of one party was created on the basis of a relative majority of the votes, as it is visible from Table 1.2.

Table 1.2 The relationship between the votes and mandates in the parliamentary elections in 1990

PARTY / COALITION	VOTES IN THE FIRST ROUND	MANDATES IN THE PARLIAMENT
HDZ	42.30 %	60.00 %
SDP	35.30 %	28.40 %
KNS	15.00 %	5.90 %
SDS	1.60 %	1.40 %
Independent	4.10 %	3.70 %
Rest	1.70 %	0.60 %
Total	100 %	100 %

Source: *Mirjana Kasapovic, Izborni i stranacki sustav Republike Hrvatske (Zagreb: Alinea, 1993): 45.*

1.1.2.2 The period of HDZ domination (1990 - 2000)

Elections undoubtedly represent the most important political process in transitional countries, given the fact that they mark the real beginning of the transformation from a totalitarian to a democratic political system. In the former Yugoslav federation, the elections represented not only a form of the delegitimation of the old political system, but also that of the former federation, and hence, they acted as a milestone on the path towards the Croatian independence and sovereignty. Despite the fact that, as we have stated before, the 1990 elections cannot be regarded as constitutional, they represent a turning point in the modern Croatian history, and therefore, they are of utmost importance. In general, one could have expected from the elections that followed to contribute to the consolidation of a young democracy, by ensuring the peaceful change of the party in power, as it was the case in other countries. However, that was not the case in Croatia. The following ten years represented an era of the absolute dominance of HDZ, where elections became a tool for the legitimation of the political situation in the country, and various types of electoral systems were changed according to the preferences of the political elites in the different electoral periods.

Despite their instrumentalisation, the numerous functions of the elections and the expectations from them in the initial stage of the post-communist period made their legitimacy almost unquestionable, so they were relatively frequently conducted. After the first elections in 1990, there have been three elections held for the House of Representatives

of the Parliament (1992, 1995, 2000), which reveals the fact that the regular term of a mandate has been shortened from four to approximately less than two and a half years till 1995. Apart from that, there have been two elections for the House of the Counties of the Parliament (1993, 1997) and three presidential elections (1993, 1997, 2000).¹⁵

As it was mentioned before, in accordance with the political preferences of the political elites, a very high level of institutional reformism marked this period in Croatia. Within only ten years, basically all major models of the electoral system were applied – the system of absolute majority (1990), two types of combined electoral systems (1992, 1995), and the system of proportional representation (2000). Given the fact that it is very difficult to find a similar trend in any other transitional country during the 1990s, it is obvious that the decision makers, by changing different systems, tried to follow the change of the preferences of the electorate and adjust the general institutional framework to the needs of the party in power.

The political system itself says much about the character of governance, since its semi-presidential form, with the strong position of the president, coupled with various mechanisms that ensured the domination of the party in power, made the constitutional declaration about the multi-party system rather questionable and the level of democratisation dependent on the ruling party's political will.

Croatia has followed the French model of semi-presidentialism as a role-model for the definition of the relations between the main subjects in its political life. The very strong position of the president in this model of political arrangement was additionally cemented by a significant lack of political culture in the country, where clientelism and populism were the main characteristics that allowed the president to govern undisputedly. Furthermore, his absolute power was ensured by the continuous dominance of his party (HDZ) in the parliament, so co-habitation, or any other form of political relations that might have endangered the dominance of the president actually never happened. Elected directly by the people and the undisputed leader of the ruling HDZ, the president has governed Croatia almost entirely unchallenged. Therefore, in fact, while pledging pure democracy, a form of a one-man rule was imposed – the president's word was usually final in the parliament and his ruling party's domination in nearly all institutions made certain that his will was implemented.

¹⁵ Apart from that, a constitutional referendum was held in 1991, up to now the only one conducted in modern Croatian history.

Accordingly, the ruling party under his governance became the main actor in the process of the creation of the Croatian state, and hence, except during the relatively short period of the coalition Government of National Unity (in late 1991 and early 1992), it became crucial in its decision-making process in almost every sphere – e.g. political, military, economic ones.

Also, one of the frequently repeated criticisms of Tudjman's time in power was the suppression of the independent media and the usage of the state television for the political purposes of the governing elites. Libel and criminal laws were combined to control the media, confrontations with nongovernmental organisations and democratic opposition parties helped to ensure government control.

At the same time, the consequences of this policy were felt in the economic field, especially during the last part of Tudjman's time in power, when severe economic problems started to show, which could not be swept under the carpet as consequences of war. The regime had surrounded itself with 'a new political-economic elite' that had gained its estate in a very questionable manner. The economy was recovering slowly from the war period, and FDI was relatively modest, mainly because of the political burdens of the Croatian political system. From 1996, Croatia even experienced numerous long-lasting labour disputes and social unrest, since unemployment remained high at almost 20%, and part of the population was living close to subsistence level.

The transition in all the ex-communist states obviously dealt a blow to the popular expectations of a rapid upturn in people's standard of living, but the results in the Croatian case, especially in comparison with the macroeconomic data before 1990s, were among the least successful. The number of employed was cut by half, the production and export declined dramatically, the tourist sector was recovering slowly, the current account deficit was rapidly increasing and, due to the negative image abroad of being semi-autocratic and unfavourable towards FDI, the country found itself in an undesirable position, without a solid base for the development of its economy. Of course, one should not forget the fact that the country went through a devastating war for its independence and the occupation of its territory for almost four years, which had dramatically influenced the overall development of the country in a very negative way.

In general, one can see that this decade of political transformation was not successful, and one can find various reasons explaining the stalemate of Croatia's development, as well as the fact that it found itself lagging behind the countries that had shown a significantly lower transitional potential in the early 1990s. However, in this turbulent decade of state-

building and war for independence, there were some paramount developments that are of crucial importance for the very existence of sovereign Croatia. First of all, the new constitution was adopted in December 1990, which was essential for the future independence of the country as its legal base, since it clearly defined the issue of national sovereignty and the new political profile of the country as well as introduced the new national symbols. Second, a referendum on independence and sovereignty was conducted in May 1991, when the people were given the chance to decide upon Croatia's future (the turn-out was approx. 85%, and approx. 94% supported Croatia's independence). This was the basis of the legitimacy of that idea and the motivation for the Declaration of Independence, which was adopted in the parliament on 25 June 1991, which represented a break-up of all bonds with the ex-Yugoslav federation and opened a new chapter in Croatia's history. Following that decision, Croatia's independence and sovereignty received international recognition on 15 January 1992.

Having achieved the formal international recognition of its statehood, the country needed to achieve another goal in order to finalise the first phase of its state-building process, and that was the liberation of the occupied territories. With two victorious military missions in 1995 (Flash in May and Storm in August), and the peaceful reintegration of Eastern Slavonia in 1998, Croatia took control over its entire territory and by achieving that, it satisfied the basic precondition for the real start of the transition process. However, it also takes political will to initiate such a process, and that is the main reason why one can conclude that the real transition started with the political changes in late 1999 and early 2000.

1.1.2.3 Croatia on a new political track (2000 – present)

On 3 January 2000, a coalition of six opposition parties, led by the centre-left Social Democratic Party (SDP) and the centre-right Croatian Social-Liberal Party (HSLHS), swept the parliamentary elections, taking 71 of 151 seats (including six seats reserved for Croatians living abroad). Following that, the presidential elections took place following the death of Franjo Tudjman, where the HDZ candidate failed to reach the second round. This represented the end of the era of HDZ's absolute dominance in the Croatian political life.

Long prepared for, the 2000 parliamentary elections were called at the end of the previous parliament's four-year term. However, Tudjman's death on 10 December moved the presidential election forward by two years, so that it almost coincided with the parliamentary elections. In fact, the presidential ballot was announced before the parliamentary elections

took place, and in effect, the two merged into a single lengthy electoral event. One good example of this argument is the fact that the parties running for parliament made campaign promises for reforming the presidency.

Table 1.3 The results of the 2000 parliamentary elections

Coalition (PARTIES)	Mandates (NUMBER)	Mandates (TOTAL)	Votes (PERCENTAGE)
SDP	43		
HSLs	25		
S-BHS	1	71	47.02%
PGS	2		
HDZ	46	46	30.46%
HSS	16		
IDS	4		
HNS	2	24	15.89%
LS	2		
HSP	4	5	3.31%
HKDU	1		
NATIONAL MINORITIES	5	5	3.31%

Source: Results of the 2000 Elections for the Croatian Parliament, <http://www.hidra.hr/stranke/501rz2000.htm>

The victory of the coalition of the opposition's parties undoubtedly opened new opportunities for Croatia's transitional reforms and the integration into the Euro-Atlantic community, processes that had been frozen for long, owing to the previous regime's lack of political will and Croatia's negative image abroad.

One crucial precondition for a new start was a structural change in the political system, i.e. reducing the unnecessarily strong position of the president and improving the parliament's position in it. It was announced by the government at the very beginning of its mandate that it wanted to depoliticize the organs of the state, which had been bastions of the nationalist party during the previous decade. In order to create institutions that citizens can start to have faith in, it planned to bring under parliamentary scrutiny especially the army, the police and the security services. The constitutional changes that took place in 2000 showed a strong determination of the new political elites to change the political praxis in Croatia, to avoid the unreasonable dominance of the executive branch and to make the state apparatus more efficient and compatible with the difficult tasks of the reform process and the EU and NATO accession. Therefore, the French model of the semi-presidential political system, which proved not to be functional in combination with the under-developed political culture in the country, was replaced with a parliamentary one, where presidential powers were significantly lowered, the role of the parliament increased, and its structure changed from bicameral to unicameral, which contributed to its efficiency and reduced costs.

The new government inherited a semi-isolated country with a weak democratic and economic system, burdened by the negative results of the shady privatisation that took place during the 1990s. The political and economic problems were likely to force a successor to remain focused on internal issues and to improve the relation with the countries in the region. Therefore, the ambitions shown by the Tudjman regime in Bosnia and Herzegovina were about to become less important not only because of the severe pressure from abroad and the fact that this was a *conditio sine qua non* for the normalisation of the country's relations with the international community, but mainly owing to the fact that any reasonable government in such a position would have been forced to increase the priority of the economic and social issues.

Besides this, unlike its predecessor, the new government showed clear political will to fulfil its obligation to fully co-operate with the ICTY. Also, very soon after taking power, it made it clear that issues that are of most serious concern for the international community, such as the return of refugees and regional co-operation, will be placed very high on the government's list of priorities¹⁶, and that some unpopular measures like rationalisation in the sectors of economy and state administration, especially downsizing the large and costly security sector, will be conducted.

After a very short period of time, it was evident that democracy had made considerable progress, as far as media rights and the freedom of expression was concerned, and that the hard-line one-party rhetoric was replaced by a much more moderate one, giving grounds to democratic dialogue. However, many serious problems were waiting to be resolved. Apart from the economic and institutional reforms, the issues related to the legacy of the war were certainly the most demanding ones, especially the co-operation with the ICTY¹⁷ and the regional co-operation, which had been made compulsory in the framework of the SAP¹⁸.

The recognisable success of the coalition government brought the country closer to the Euro-Atlantic community and changed the overall picture of Croatia abroad. It had started the painful process of the transitional reforms, changed the political discourse and brought the country 'back on the right track'. Nevertheless, the situation was everything but rosy, owing

¹⁶ Full co-operation with the ICTY, the return of refugees and regional co-operation were the three main conditions for the normalisation of relations with the international community, and with the EU in particular. Since these issues were of utmost importance, marking the political life in Croatia in the last decade, they will be thoroughly examined in the next chapter.

¹⁷ ICTY – International Criminal Tribunal for former Yugoslavia.

¹⁸ See details on the process later in the text.

to the difficult political and economic reality, burdened by complicated relations with the region, the EU, NATO, and a number of other problems.

Still, the major problem for the government which was negatively affecting the coalition's effectiveness was in fact due to the way it had been formed. It was based on 'the old Croatian syndrome' of voting and acting 'against' rather than 'in favour' of some political option. Namely, the modest experience of the Croatian statehood has shown that if we put aside the declarative statements of the highest party officials, their pre-election behaviour was mostly a display of the intention to discredit their political opponents rather than to offer 'something concrete' as an alternative.

Accordingly, the Croatian electorate was following their example, and by voting for a change, they opted to punish the incumbent government rather than in favour of some coherent alternative political programme. A vote for HDZ in the early 1990s was a vote against the failed state of Yugoslavia, Serbian domination and aggression, as well as against the un-fair federal financial system, which was perceived as transferring an enormous amount of funds (on an annual basis) from the more developed republics (Slovenia and Croatia) to the others in the name of the 'balanced development of a common federation'. The alternative was very clear – loosening the federal model, or independence. On the other hand, the way HDZ governed the country during the 1990s revealed the fact that the political elites were 'not quite sure' what they had in mind while declaratively opting for an independent and European Croatia, simply because their 'anti-program' replaced their actual program.

Exactly the same situation happened in 2000 – a vote for the opposition was in fact a vote against the semi-autocratic regime of HDZ, as well as against international isolation, economic backwardness, shady privatisation, corruption, and the limitation of the freedom of expression. It took a broad compromise to overthrow HDZ, so a wide coalition was formed, which consisted of various parties that had different political priorities and apparently only one thing in common – the determination for political change. The wide structural diapason of the government 'stretched' from, for example, the Istrian Democratic Union as a moderate regional party of the most developed Croatian county, which was oriented towards SME development, tourism and cross-border regional co-operation, to the Croatian Peasants Party, which advocated the importance of traditional Christian values and state subsidies in the agriculture. Additionally, the economic pressures drove the main party in the government, the Social Democratic Party, to taking immediate actions to cut the unsustainable welfare system and by doing so to acting in direct contradiction with its political profile. This type of mish-mash heterogeneity with unclear and conflicting political preferences, accompanied by a

burdensome political and economic situation, had a negative impact on the government's functionality and popularity.

Table 1.4 The results of the 2003 parliamentary elections

PARTY / COALITION	VOTES (PERCENT)	MANDATES (NUMBER)
HDZ	43.42%	66
SDP	19.08%	29
HSS	6.58%	10
HNS	6.58%	10
HSP	4.61%	7
IDS	2.63%	4
LIBRA	1.97%	3
HSU	1.97%	3
SDSS	1.97%	3
HSLŠ	1.32%	2
LS	1.32%	2
DC	0.66%	1
PGS	0.66%	1
SDA	0.66%	1

Source: Results of the 2003 Elections for the Croatian Parliament, www.hidra.hr/stranke/sabor.htm

The election victory of the HDZ in 2003 raised a huge question mark over Croatia's future and its relations with the international community and the countries within the region, as well as serious doubts about the perspectives for the country's economy and its citizens' living standards. Although the coalition government showed some severe weaknesses, especially during the last two years of its mandate, it left the country in a much better shape both in the domestic and the international fields than in 2000, when it took office. Therefore, the outcome of these elections provoked some serious questions in the country and abroad. Was Croatia going backwards to the 1990s in terms of rhetoric and politics? Could the severe malfunctions of the political system of that time be expected again? What about the future role of Croatia as a proof that successful reforms in this turbulent part of Europe are possible and that the SAP really works? These are just some of the questions that were raised at that time.

After their severe defeat in the 2000 elections, the HDZ was at a crossroads – to transform into a regular European centre-right party or literally cease to exist as a recognisable player in the Croatian political life. A new leadership was elected and its new President, Ivo Sanader, former Deputy Minister of Foreign Affairs and Chief of the President's Office during the Tudjman time, started the initiative of reshaping the party in accordance with its new pro-European programme and cleansing it from backward oriented

right-wing extremist persons, who simply could not find their place in the new political framework. Also, not only the HDZ, but also the whole political pre-elections discourse started changing, and concrete programs and 'votes in favour' started replacing the political mud-slinging and the 'votes against'. The way the government was formed was another good sign of change – since it did not have a clear majority to form the government alone, it was forced to find some support in the other parties that made it to the parliament, and instead of taking the easy way out by forming a coalition with the right-wing Croatian Party of Rights (HSP)¹⁹, HDZ managed to find a partner elsewhere – in the Pensioners Party and the representatives of the minorities (including the representatives of the Serbian minority). This gave it a lot of credit abroad.

The last elections, held in November 2007, have shown a trend of electoral bipolarisation in Croatia, where the two biggest parties (HDZ and SDP) won approximately 80% of the votes. However, taking into consideration the fact that neither of them managed to win enough mandates to be able to form a government individually, the importance of small coalitions and parties has increased dramatically, becoming a typical example of 'pivot parties'²⁰.

For the first time in country's history, the coalition agreement was thoroughly negotiated, and the details of the coalition's future work were agreed upon and specified in a document of more than 100 pages. The experience of the relatively inefficient coalition from the term 2000-03²¹ led the partners to the conclusion that it is important to precisely define the details of their future co-operation in order to avoid political turmoil and technical complications in the time to come. After lengthy negotiations, which proved to be too long with regards to the pace of reforms in the process of the EU accession, HDZ formed a government with HSS-HSLS (the Croatian Peasants Party and the Croatian Social-Liberal Party), HSU (the Croatian Party of Pensioners) and the representatives of the minorities. Two significant signs of democratic maturity were visible. Firstly, the representative of the Serbian

¹⁹ This was the only party, apart from those from the opposite end of the spectrum, which won enough seats that can guarantee the stability of the government without a need for another partner.

²⁰ 'Pivot party' is a party without which no one else can form a government. In the situation where it was difficult to expect that 'a big coalition' (HDZ and SDP) would be formed, not so much because of the unbridgeable differences but more due to the lack of political will and culture on both sides, it was not only that coalitions like HSS-HSLS were important (8 mandates) but negotiations were conducted with each MP from minor parties or the representatives of minorities.

²¹ This coalition found it difficult to work on the basis of a three-page document. A broad compromise, which was needed to overthrow the HDZ, proved to be insufficient for the sustainability of the six-party coalition government. This was one of the major reasons why they moved to opposition in 2003.

minority was appointed Vice-president of the government, which is a very important step, bearing in mind Croatia's recent history. Secondly, for the first time in Croatia, the Roma community has its own representative in the parliament, which will help articulate the specific position of their population in the society and help their integration in it.²²

Table 1.5 The results of the 2007 parliamentary elections

PARTY / COALITION	VOTES (PERCENT, APPROX.)	MANDATES (NUMBER)
HDZ	42 %	66
SDP	37 %	56
HSS-HSLS	5 %	8
HNS	5 %	7
HDSSB	2 %	3
IDS	2 %	3
HSP	1 %	1
HSU	1 %	1
NATIONAL MINORITIES	5 %	8

Source: State Electoral Committee of the Republic of Croatia, Report on the Elections for Croatian Parliament (November 2007), <http://www.izbori.hr/izbori/izbori07.nsf/FI?OpenForm>

The present coalition successfully went through some difficult decisions (the cancellation of the Protected Ecological Fishery Zone, the recognition of Kosovo's independence, etc.). The invitation to join NATO, which was received at the Bucharest Summit, as well as the first official visit of the US President that followed, seem to be a confirmation of the quality of Croatia's work and a solid motivation for the endeavours to come. However, the very demanding schedule of reforms for the next year on the country's path towards a full-fledged EU membership, which will have to include some tough decisions influencing some strategic branches of the economy (e.g. the termination of state subsidies in the ship-building industry and the agriculture), not to mention the problems with judiciary efficiency and the fight against corruption, will be the best test for its stability and the level of political maturity in Croatia.

²² Because of the importance of the minority rights issue, this topic will be discussed in detail in the following chapter.

1.2 The implementation of the EU's democratic requirements: Transparency, decision-making processes, the role of civil society actors, minority rights, the rights of the political opposition

As it was stressed before, the importance of the EU democratic requirements is relatively difficult to estimate for the period before the year 2000, bearing in mind that it represented the first constructive approach of the EU towards the region that included the possibility for the countries of the region to become a part of it once they meet the required criteria. Prior to that, in the absence of political consent within the EU, it was difficult for it to provide any kind of political framework that could have stimulated the reform process in the region, and hence, to rely on its well-known conditionality mechanism, which had been frequently used in its relations with the countries of Central and Eastern Europe.

Therefore, a milestone of Croatia's change of course after 1999 was the EU's Stabilisation and Association Process, with its own merits policy of distinction, and the perspective of the EU membership, which brought an entirely different dynamics to the country's political life. The previous vague framework that had caused so many suspicions was finally enriched with some new elements, which gave new energy to the country's reform process. Owing to the turbulent past of the region, and its consequences, which were still visible, apart from the standard political requirements formulated in the Copenhagen Criteria, the EU defined three important obligations for the countries of the region, or better to say, *conditio sine qua non*'s, for the improvement of their relations with the EU and their progress in the process of the EU accession. These are as follows: full co-operation with the ICTY, regional co-operation and the return of refugees (directly related to minority rights). Since these conditions were crucial in the assessment of the country's ability to meet the EU's democratic requirements and successfully conduct the very difficult process of reforms on its way towards membership in the Euro-Atlantic community, we will thoroughly examine these issues here.²³

²³ Owing to the fact that the minority issue is rather complicated in Croatia and directly related to several issues that are of significant importance, such as the dissolution of former Yugoslavia, the Homeland War, the return of refugees, as well as to the fact that it has different implications for the political life in the country and its Euro-Atlantic perspective, it will be analysed with special attention in the pages to come.

1.2.1 Co-operation with the ICTY

The first condition was troublesome because it raised painfully sensitive political topics, which go deep into the very core of the Croatian independence. It required the critical re-examination of the role Croatia played during the war and the responsibility of its generals, who had been celebrated as national heroes. Furthermore, the extradition of the accused persons to the ICTY also triggered the issue of the legitimacy of the government to do it, as the government was run by the party that succeeded the communist one from the ex-Yugoslavia times and was still regarded in that manner by a significant part of the right wing oriented population.

The problem was further complicated by the fact that the country had obviously been the victim of an aggression, and the government found it very difficult to move the political discourse on this particular issue from the variety of senseless attempts to prove the impossibility of committing a crime in a defensive war. Inevitably, the conditions imposed on Croatia by the ICTY were often compared with those imposed on Serbia and were criticised as comparatively too harsh, given the responsibility that Serbia ought to bear. Therefore, it required a lot of courage and determination on the part of the country's officials to continue implementing the defined goals, and maybe the best example for this, is President Stjepan Mesić's decision to retire seven generals in the autumn of 2000 for publicly criticising the government's crackdown on persons suspected for war crimes. This was of special significance due to the importance and image that the army had in the country during these days – that of the national liberator and a crucial pillar of Croatia's independence and statehood. Therefore, the president's decision can be regarded as a solid sign that the civil oversight of the military would be taking place after the gloomy 1990s.

After the 2003 elections, the HDZ government decided to use its first couple of months in the office, relying on the 'post-election honeymoon' period, to start the most unpleasant moves it was obliged to make. Therefore, it was very efficient in the extradition of a number of Croatian citizens to the ICTY, and it achieved a level of co-operation with the tribunal without serious turmoil that had been unthinkable in the period of the SDP-led coalition government because of the party's communist past. Only one person remained at large, managing to get out of the reach of the Croatian authorities and hide until December 2005, significantly burdening the country's relations with the ICTY, and accordingly, with the rest of the international community, and the EU in particular.

Moreover, because of that problem, Croatia would probably be remembered as the only country whose membership negotiations with the EU were postponed after a clear date for their start had been set. This was, of course, warmly welcomed by a number of Euro-sceptics, who rushed to prove that this was just another clear sign that 'Europe does not want Croatia anyway'. They managed to significantly decrease the public support for the process, mainly owing to the lack of solid counter-argumentation from the government's side at that time, not to mention any sustainable PR campaign. It was a sobering experience, and although it was difficult to defend the position of the ICTY Chief Prosecutor that "Croatia is not showing the political will to co-operate fully", especially after the government's performance during its first months in office, it was obvious that the country failed to deliver on its promise, and if there was no problem with the determination to co-operate, there was surely one with the democratic oversight of the security sector.

Therefore, capturing the last fugitive represented not only a display of the determination to fully co-operate with the ICTY, which was never questioned after the 2000 democratic changes, but a consolidation of the security sector as well, i.e. the achievement of the ability to conduct it in practice. Having solved this issue, the country has managed to remove the last major obstacle from its accession track, and finally it came into a position where it can perform in the EU accession negotiations, which started in November 2005, without heavy and rather limiting political pressure from abroad as well as from within the country.

However, one should not forget to take into consideration the broader political context in which the European Council's decision to start the negotiations with Croatia has been made. It was the time when 'more important decisions' were about to be made. The issue of the initiation of the membership talks with Turkey proved to be very difficult for the EU in terms of achieving a compromise, i.e. a common position. It was interesting to see how a small country like Austria, which was highly sceptical about the Turkish EU bid and supportive of the Croatian one, managed to use the decision making procedure of the European Council (the unanimity requirement for enlargement issues), and inter-relate the solutions for the two, and hence, pave the way for Croatia. Apart from that, the statement of ICTY Chief Prosecutor Carla del Ponte coincided with the aforementioned political decision and gave a sort of legitimation to it, opening the floor for various interpretations about the links between the two.

1.2.2 Regional co-operation

Another issue, not much easier than the previous one, was regional co-operation, which was provoking a lot of tensions and doubts in the country, owing to the lack of the clarity of the concept on the one side and some unreasonable fears on the other. Although it was logical from the EU's point of view, the condition was often perceived as a step back towards some form of old/new Yugoslavia. Since the country had just managed to consolidate itself after getting back its occupied territories Croatia was reluctant to rush into anything that looked like the undesirable framework it wanted to leave behind, despite the fact that it opened the perspective of EU integration. On the other hand, one should not underestimate the fact that some parts of the Croatian society were doing their best to feed these fears, owing to the fact that moving closer to transparency, as required by the EU, meant facing some unpleasant questions about their political activities during the previous decade and the origins of their wealth. This problem was additionally burdened with the unresolved questions of the refugees, managing the former Yugoslavia's debts and assets, as well as certain unsettled territorial disputes between the region's countries.

But at that moment, during the first part of this decade, it was of utmost importance for the coalition government to prove its readiness for serious changes and to adopt policies compatible with the European democratic standards. The government's declarations were constantly tested against the new requirements and the different pressures from the international community and the EU in particular. It was obvious that, apart from the general Copenhagen criteria required from all countries on their path towards EU membership, the focus would remain on those additional ones originating from the Dayton Peace Process that were mentioned before. These basic elements would determine what the image of the new European Croatia would look like and reveal the country's potential to be able to become a member of the European Union.

An issue of serious concern after the HDZ political comeback was its policy towards the region, but after Croatia solved its major political and security problems, regional co-operation became the rational choice for the sake of the national interest for various reasons, especially ones of economic nature. It is also useful to mention that the HDZ government found itself in a much better position regarding this than its predecessor, owing to the fact that in 2003 the country's future was much clearer than in 2000, so it was much easier to invest in regional co-operation while having 'a solid back-up' in a visible EU membership

perspective, which was confirmed by the candidate country status that was granted to Croatia in 2004.

Indeed, there are several examples proving the fact that Croatia went beyond the 'basic regional co-operation' required by the EU and started building more constructive relations with its Eastern neighbours, as well as helping them in their reform process and their EU and NATO bid. Having achieved a respectable pace of accession to the Euro-Atlantic structures, and hence, feeling less punished for being cemented in an undesirable framework, the country was finally able to channel more energy into regional co-operation not only because of its own economic, security and other interests, but also because it was an excellent opportunity to show that it is significantly contributing to the efforts of the international community and the EU in particular, for the stabilisation and sustainable development of the region.

With regard to **Bosnia and Herzegovina**, Croatia has shown the political will to support its state-building and democratisation, and hence, it plays an active, although limited, role in the EU mission in BiH, acting as a host-support nation. Croatia has been providing extensive and vital logistical support to all operations that involve air-sea-land transit or support bases. Even though Croatia has not been asked to contribute troops to ALTHEA, it has been providing free air control services, and it has done the same for the KFOR Operation in Kosovo²⁴. Since the officials from Zagreb, regardless of their political orientation, are doing their best to remain transparent and not 'step on thin ice' in their relations with the Croatian parties from BiH, the only issue that appears to be a disputable one is the right of the Croatian citizens residing in BiH to vote in Croatia. The debate is ongoing over the question whether 'a constitutive nation' in a neighbouring country could be regarded as a diaspora, and hence, it should be given the right to vote, just like the Croatians in other countries all over the world, or should the system follow the 'no representation without taxation' logic. However, the fact that the debate intensifies mostly during the election year signals that it is more an issue of pre-election mathematics rather than being of high political significance.

A good example for this is the consequences of the change of the HDZ policy on supporting the voters in BiH and the reaction of their political opponents. Namely, the fact that HDZ started losing its traditional support in BiH forced the 'loudest opponent' of the existing settlement, the SDP, to reconsider its position on the particular issue and to try

²⁴ Additionally, Croatia has been providing EUFOR with medical support as well.

gaining some votes there by nominating candidates that are 'suitable for the targeted group'. Therefore, despite of the rather 'benign' nature of the issue, the confusion and misinterpretations that it sometimes brings into the relations between the two countries, especially from the point of view of the international community, should be good motivation to have it clarified sooner rather than later.

The co-operation with **Montenegro**, after it gained its independence, is positively developing, especially owing to the fact that there are some positive signs from Podgorica about the political will to take responsibility, at least on a declarative level, for the role of the Montenegrin troops in the aggression on Croatia during the early 1990s. Symbolic gestures worth mentioning are the initiation of the discussion on the highest political level about this problem, as well as about the possibilities of a compensation for war damage, and the decision to grant the Croatian president the status of honourable citizen of Podgorica. On the other hand, Croatia shows the political will to help Montenegro, and it seems that it has started to take some concrete measures in that regard. However, despite the fact that this is a recognisable improvement of the relations between the two countries, there is a wide range of opportunities that are still open, and there are several examples, especially from the business sector, that give us good reason to believe that it will happen in the future.

Relations with **Serbia** are also stable and slowly improving, although there is no clear sign from Belgrade about the preparedness to follow the Montenegrin example in facing the recent past, and hence, opening a new chapter in their relations with Croatia. The very modest attempts, such as the one by Serbian President Tadic (June 2007), have been welcomed by the Croatian officials, although they had been taken with reservations, especially with regards to the occasion in which the statement was issued and its formulation. It is also true that it is difficult to expect further significant improvement to happen these days, given the fact that Serbia is facing a difficult period in its democratic development, and it is especially burdened with the resolution of Kosovo's status and its troublesome relations with the ICTY, as well as coping with the frightening extent of public support for the radical option.

However, Croatia is showing support for its democratisation in different ways – perhaps the best practical example, apart from the positive spill-over effect of its success in the reform process, is the assistance to the Serbian government on the aforementioned issue of co-operation with the ICTY. A good example for this is the fact that the Croatian State Prosecutor's Office assisted in preparing the strategy and implementing the plan for the extradition of the fugitives that are still at large on the basis of Croatian experience. On the other hand, the Serbian minority in Croatia, which is politically represented in the

government, tends to react rather pro-actively to its inclusion in the decision making process and takes the role of a link between the two countries, in contrast with the practice of the recent past.

Croatia's relations with **Albania and Macedonia** were never burdened with burning political issues, so they are developing constantly, both bilaterally and in the form of the Adriatic Charter. The mutual support for the EU and NATO bid was always clear, and especially Macedonia benefited from this co-operation, using different Croatian translations of the *acquis* documents.

With regards to **Kosovo**, Croatia is contributing to its stability in accordance with its capabilities and under the umbrella of the international peacekeeping and democracy-building missions. The participation of the Croatian staff in the UNMIK and OSCE missions to Kosovo proved to be very successful, and thanks to this, it is expected that the Croatian personnel will take part in an ESDP mission (*EULEX*), which is planned to be initiated after the resolution of Kosovo's status. Furthermore, in accordance with its general harmonisation with the EU policies, it can be expected that Croatia will keep on supporting the EU policies in Kosovo.

Despite the fact that **Slovenia** is rarely considered as a part of the region, some unsettled disputes are providing relations between the two countries with plenty of dynamics, and therefore, they deserve to be mentioned here. Fifteen years of independence has obviously not been enough for the two friendly states to resolve the issues of their common border, the debt of '*Ljubljanska Banka*' (Ljubljanska Bank) to Croatian citizens, and the common management of the Krsko nuclear power-station. However, one should not overestimate the importance of the occasional tensions between the two sides, especially since they tend to occur only during the pre-election period in both countries, as well as the fact that these disputes are completely overshadowed by the successful co-operation in a number of other fields.

Of course, all these relations are far from perfect, and there is much to be done, but it is an undeniable fact that Croatia has enhanced its relations with the countries from the region by taking a pro-active attitude, especially after it managed to pave its own way towards the EU membership.

Indeed, it has always been much easier, and 'less dangerous', to deal with the region in a bilateral rather than a regional form, especially from the point of view of a country that has always been very careful and reluctant to rush into something unfavourable. However, the success of Croatia's EU and NATO bid had loosened the tension in this regard as well,

and it enabled the country to take a more constructive role in the regional co-operation frameworks, especially in those whose membership is not limited to the SAP countries. Croatia is a member of a number of regional organisations and initiatives, but a detailed explanation of its participation in each of these goes way beyond the limits of this paper, so the focus will be kept on those that seem to be the most important and interesting ones.

The establishment of a **free-trade area** in the region was one of the few high priorities of the EU, owing to the fact that it was supposed to simplify the economic flows within the region by combining thirty-one bilateral agreements into one multilateral free trade agreement, and hence, hopefully attract FDI, help the countries to prepare for a tougher competition on the EU market once they join it, and contribute to their economic development in general. Croatia reacted constructively to the initiative from Brussels, proposing the extension of the already existing CEFTA to the region and beyond. Apart from Croatia and Macedonia, and of course Bulgaria and Romania, who were just about to leave it because they were joining the EU, no country from the region was part of it simply because they were not meeting the criteria to become one. Therefore, it seems that this initiative proved to play a significant role in granting a CEFTA membership to the countries of the region and Moldova without meeting the criteria, even if one regards it as a smooth manoeuvre to avoid the proposal of the WBFTA, without being exposed to an accusation for a lack of regional co-operation. Obviously, this framework was not recognised as a politically recommendable one, so, having landed successfully after a manoeuvre with a pretty high altitude of political risk, Croatia managed to avoid rushing into a politically possibly undesirable package, while positively responding to the economic part of the EU's proposal, i.e. the one presented as the crucial reason for the whole initiative.

Continuing the assessment from an economic point of view, it is important to underline that the country will also have the opportunity to profit considerably from improved regional cooperation, bearing in mind that its economy is much stronger and more competitive than that of the others from the region. The endless debates that took place before the agreement was signed, as well as the unsuccessful attempts of some countries to retain some protective measures, show that many of them will have serious problems in terms of economic competition with Croatia. On the other hand, having in mind the trade deficit with the EU, the whole framework can be used as a good opportunity for the country to balance it out at least to a certain extent.

In accordance with the obvious trends and the needs for regional ownership in South East Europe, Croatia tends to show an understanding of the importance of the regionally

initiated co-operation frameworks, and its chairmanship of **Southeast Europe Co-operation Process (SEECP)** in 2006-07 seems to be a promising example. One special characteristic of the SEECP is exactly that it is a unique form of co-operation among the countries in the region, launched on their own initiative. In that regard, SEECP seeks to define itself as the authentic voice of South East Europe, being complementary to the EU accession process of the countries in the region, and going hand in hand with the transformation and the gradual phasing out of the Stability Pact for Southeast Europe. According to the *Report on the activities of the Croatian Chairmanship-in-Office of the Southeast European Co-operation Process (SEECP) May 2006/May 2007*²⁵, the activities of this year were focused on strengthening regional ownership, promoting the European dimension of the region and enhancing the operational capabilities of the regional co-operation, as well as intensifying the co-operation among the parliaments and in the fields of energy, home and justice affairs.

In view of the European integration of the countries of the region, the Chairmanship gave special attention to intensive co-operation with the EU, and the participation of the EU representatives in all SEECP meetings and activities.

Apart from the list of other activities, the report lists the following overall achievements:

- Strengthening the political dialogue, and thus, contributing to stability and security in South Eastern Europe, as well as the rapprochement of the countries of the region to the EU and the Euro-Atlantic structures;
- The enhancement of the SEECP through amending the Charter on Good Neighbourly Relations, Stability, Security and Co-operation in South Eastern Europe;
- The designation of the Seat of the Regional Co-operation Council Secretariat, and the appointment of the Secretary General of the RCC, thus contributing to setting up the regional co-operation structure;
- Successful co-operation with the European Commission, the Stability Pact and the donors in the establishment of the new regional co-operation architecture, especially its operational capabilities;
- Intensifying regional co-operation in the fields of energy, home and justice affairs, and parliamentary co-operation.

²⁵For the whole document, see the Official Website of Croatian Government, www.vlada.hr/hr/content/download/16888/198789/file/07.05.11.Report%20on%20the%20activities%20of%20the%20

Croatia also supports the transformation of the Stability Pact to a regionally owned co-operation framework, the **Regional Co-operation Council (RCC)**. By the end of 2008, a new framework for regional co-operation called the Regional Co-operation Council (RCC) will bring together the representatives of South Eastern Europe, including UNMIK/Kosovo, with the representatives of the international community. This should ensure that the unique composition of the Stability Pact's Regional Table, where all countries participate on an equal footing, is maintained. While the SP currently works in 25 different areas via its task forces and some secretariats located in the region, the RCC will focus on five priority areas: economic and social development; infrastructure; justice and home affairs; security co-operation; building human capital and parliamentary co-operation - an overarching supporting theme. A decisive step of the transformation of the internationally led Stability Pact for South Eastern Europe into the regionally owned Regional Co-operation Council (RCC) was made on 10 May 2007, when the Regional Table of the Stability Pact endorsed the nominations of the RCC's first Secretary General and the seat of the RCC Secretariat, and it adopted the RCC Statute. Decisions to endorse the nomination of the State Secretary at the Ministry of Foreign Affairs and European Integration of Croatia to be the RCC's first Secretary General can be regarded as the recognition of the country's proactive attitude towards the region and a good opportunity to show its determination to continue improving in this area.

1.2.3 Minority rights

The violation of human rights and the rights of national minorities was one of the main criticisms of the nature of the political system in Croatia during the 1990s. While analysing these issues, one has to take into consideration the fact that the country inherited a legislative base for the protection of the rights of national minorities from the former Yugoslav federation which dealt with the minorities that were recognized at that time (the 'old minorities'), but the issue of the 'new minorities' was not resolved. Although some efforts were directed towards solving the minority issues during the 1990s, true efforts were shown only in 2000, with the adoption of the Law on the Education of National Minorities and the Law on the Use of the Language and Letter of National Minorities, and especially with the introduction of the Constitutional Law on Minority Rights (CLNM) in 2002.

It is useful to mention that the rights of national minorities were seriously violated in the former Yugoslavia in the period before the 1974 Constitution. In the framework of the constitutional changes, three laws dealing with minority rights were adopted:

- Law on the rights of individuals as members of national minorities;
- Law on the collective rights of national minorities;
- Law on the control mechanisms of the implementation of the rights of national minorities.

On this legal basis, every citizen of the former Yugoslav federation had the right to express his or her identification with any nation or national minority. Furthermore, the legislation forbade the spreading of any national, racial and religion based hatred. Besides the basic human rights related to the remarks above, the members of the national minorities had the freedom to use and practice their culture, language and letter before the judicial institutions and the institutions of public administration.

Each federal republic adopted a constitutional law and developed specific laws that define the basic rights of the national minorities in the society and develop a framework of specific political relations between the majority and national minorities. For instance, the Socialist Republic of Croatia adopted laws protecting the rights of minorities that guarantee their representation at the state and local level and participation in the bodies of the state administration. Also, special commissions were appointed at the local and state level, to supervise the implementation of these legislative guaranties.²⁶

The education in the language of the national minorities was guaranteed by five laws in the Socialist Republic of Croatia, creating a bilingual model of education and a well developed and organized cultural life for the members of the Hungarian, Czech, Italian, Slovakian, Russian and Ukrainian national minority.²⁷

All the above-mentioned laws were implemented in the legislation of the Republic of Croatia in the 1990s. However, the laws were related to only one part of the society, leaving the rights of the 'new minorities', the people of the republics of the former Yugoslav Federation, unprotected. The international community demanded a reform and strong legislative for the protection of the 'new minorities' in Croatia regarding the post-war climate in the society, especially towards the Serbian minority. By adopting the Constitutional law on

²⁶ Budakar Vukas. *Etnicke manjine i medjunarodni odnosi*, (Zagreb: Skolska knjiga, 1978)

²⁷ Mirjana Domini, *Manjine u Alpsko-Jadranskom prostoru (Hrvatska)* (Zagreb: Institut za migracije i narodnosti Sveucilista u Zagrebu, 1990)

the protection of the national minority rights and by ratifying the international conventions regarding minority issues, the Republic of Croatia only adopted a platform for national minority rights protection. Owing to the lack of political will at the time, until 2000 none of the actual laws were practiced in reality. The issue of the protection of the national minority rights was one of the major preconditions of the international recognition of Croatia's sovereignty, and one of the major long-term international obligations put before the country as a subject of monitoring.

The demographic changes during the 1990s had a major impact on the structure of the population, and therefore, on the size of the national minorities' community in Croatia as well. There was no national minority living in a geographically rounded area, and therefore, none was entitled to ask for territorial autonomy. Generally, the national minorities required only the protection of the main national minority rights, as it was stated in the Constitutional law: the representation of minorities at the local and state level, the freedom of cultural identity, and religious freedom and education using the language of the national minorities. Therefore, one may conclude that the issue of the preservation and protection of the national minority rights at that time was a question of identity, not power.²⁸

By comparing the 1991 and 2001 demographic censuses, we can see major demographic changes, especially the decrease of the minority population and the increase of the size of the majority population in Croatia.

The results of the demographic census in 2001 showed a major change in the ethnic structure of the population compared to the year 1991. In the year 2001, the major national minorities were the Serbs with 201,631 members or 4.54%, followed by the Bosnians with 20,755 members or 0.5%, the Italians with 19,636 members or 0.4%, the Hungarians with 16,595 members or 0.4%, the Albanians with 0.3%, the Slovenians with 13,173 members or 0.3%, the Czechs with 10,510 members or 0.2 %, the Roma with 9,463 members or 0.2%, the Montenegrins with 4,926 or 0.1%, the Slovaks with 4,712 members or 0.1%, the Macedonians with 4,270 members or 0.1%, the Germans with 2,902 or 0.1% and the Russians with 2,337 members or 0.1%, the Ukrainians with 1,977 members, the Jews with 576 members, the Poles with 567, the Romanians with 475, the Bulgarians with 331, the Turks with 300, the Austrians with 247 and the Vlahos with 12 members in the total number of the population.

²⁸ Sinisa Tatalovic, *Nacionalne manjine u Hrvatskoj* (Split: Stina, 2005).

Table 1.6 Demographic census – Data on national minorities in Croatia in 1991 and 2001

	Total 2001	%	Male	Female	Total 1991
Republic Croatia - total	4,437,460	100.0%	2,135,900	2,301,560	4,784,265
Croats	3,977,171	89.6%	1,912,953	2,064,218	3,736,356
National minorities - total	331,383	7.5%	158,990	172,393	
Albanians	15,082	0.3%	8,653	6,429	12,032
Austrians	247	0.0%	100	147	214
Bosnians	20,755	0.5%	10,896	9,859	43,469
Bulgarians	331	0.0%	157	174	458
Montenegrins	4,926	0.1%	2,738	2,188	9,724
Czechs	10,510	0.2%	4,930	5,580	13,086
Hungarians	16,595	0.4%	7,482	9,113	22,355
Macedonians	4,270	0.1%	2,018	2,252	6,280
Germans	2,902	0.1%	1,254	1,648	2,635
Poles	567	0.0%	116	451	679
Roma	9,463	0.2%	4,777	4,686	6,695
Romanians	475	0.0%	203	272	810
Russians	906	0.0%	174	732	706
Russins	2,337	0.1%	1,125	1,212	3,253
Slovakians	4,712	0.1%	2,180	2,532	5,606
Slovenians	13,173	0.3%	4,215	8,958	22,376
Serbs	201,631	4.5%	97,481	104,150	581,663
Italians	19,636	0.4%	9,210	10,426	21,303
Turks	300	0.0%	183	117	320
Ukrainians	1,977	0.0%	832	1,145	2,494
Vlahos	12	0.0%	7	5	22
Jews	576	0.0%	259	317	600
Other	21,801	0.5%	11,267	10,534	3,012
No answer					
Total	89,130	2.0%	43,537	45,593	73,376
Regional	9,302	0.2%	4,757	4,545	45,493
Unknown	17,975	0.4%	9,153	8,822	62,926

Remark: In the demographic census in 2001, 19,677 citizens identified themselves as Muslims.

Source: Central Bureau of Statistic of the Republic of Croatia, Information on population of national minorities in Croatia, http://www.dzs.hr/default_e.htm

The reduction of the national minorities was evident: Serbs - 65%, Montenegrins - 49%, Slovenians - 41%, Macedonians - 32%, Russians - 28%, Hungarians - 25%, Ukrainians - 20%, Slovakians - 15%, Italians - 7%, while the increase of the national minorities was evident for the Roma - 41%, the Albanians 25% and the Germans - 10%. The main reasons for the decrease of the size of the national minorities are:

- The consequences of the Homeland War that took place from 1991 to 1995;
- Geographical reasons - the dispersal of the members of national minorities;
- Urbanization and the migration of the rural population to cities, which leads to the weakening of village communities;
- The migration of the population abroad, especially during and after the Homeland War;

- The higher education of the members of the national minorities, which leads to social moving;
- Mixed marriages;
- The weakening of cohesive elements, replaced by identification with professional, social or regional groups.²⁹

It is important to emphasize the fact that the demographic census in 1991 should be assessed with a certain amount of reservation because many Croats, Serbs and Bosnians identified themselves as Yugoslavians in 1991 and by 2000 changed their declaration. This should be interpreted as a reflection of the positive change of the political climate for the national minorities.

The 1990 Constitution of the Republic of Croatia constituted Croatia as a “... national state of Croatian people and the members of other people and minorities that are citizens of Croatia: Serbs, Muslims, Slovenians, Czechs, Slovaks, Italians, Hungarians, Jews and others to whom the state guarantees equality with citizens of Croatian nationality.”³⁰

The regulation of minority issues in the Constitution was not thorough and adequate according to the reports of the international community, and therefore, it needed changes. Hence, Croatia had to improve the legislative framework for minority rights by adopting a Constitutional Law on Human Rights and Rights of National Minorities (1992) and by trying to follow the examples of countries such as Hungary, Estonia and Latvia, as they were considered to be ones that had achieved significant progress in this area. The main issues related to the context of the constitutional law were:³¹

- The general protection of national minorities;
- The institutionalization of cultural autonomy;
- Development and equality;
- Co-operation with the 'home countries';
- The right for non-discrimination, identity, religion and culture;
- The right for the public and private use of language and letter;
- The use of national symbols;
- The bilingual use of city and community names in some cases;

²⁹ Ibid, str. 26

³⁰ The Constitution of the Republic of Croatia, Preamble.

³¹ The Constitutional law on human rights and freedoms and rights and freedoms of national minorities, 1990, <http://hrvatska.poslovniforum.hr/nn-arhiva/0003e/03e89.asp>

- The education of the members of the national minorities at all levels (this issue was thoroughly explained in the special law afterwards)
- The representation of the members of the national minorities at the local and state level.³²

The Constitutional Law on Human Rights and Rights of National Minorities was, without any doubt, in accordance with the highest standards recommended by the international community. However, mainly due to the consequences of war, the total size of the national minority decreased below 8% of the total population, which negatively affected the representation of minorities in state institutions, not to mention at the local level.

The adoption of the new Constitution Law on Minority Rights in 2000 made certain changes regarding the protection of minority rights:

- The full protection of the principle of non-discrimination;
- Full protection against any action aimed to endanger national minorities;
- The right for identity, culture, religion, the public and private use of language and letter as well as education;
- Equal participation in public affairs;
- The right of each person to decide to which national minority s/he belongs.³³

The implementation of the Framework Convention for the Protection of National Minorities was extremely important for the protection of the rights of national minorities in Croatia. Croatia's first report on the implementation of the aforementioned Framework Convention in 1999 showed, besides the general efforts to improve the position of the minorities, the obstruction of their rights by the state administration. Major efforts were invested into the organisation and work of the Government's Office for National Minorities, which managed to function despite the generally inadequate political climate through programs and different types of co-operation with NGOs dealing with national minority issues. Another essential document for the protection of national minority rights is the Convention for the Protection of Regional and National Minority Languages, upon which Croatia adopted the Law on National Minority Languages and Letter. As a member of the Council of Europe, Croatia has adopted many legal obligations and taken many concrete obligations in this regard, such as

³² The national minorities that are represented in the total demographic census by more than 8% had the right to be represented in the parliament, the government and the judicial institutions.

³³ The Constitutional law on human rights and freedoms and rights and freedoms of national minorities 2000.

the ratification of the Framework Convention for the Protection of National Minorities, co-operation with ICTY, following the Dayton agreement, the respect of human rights, the rights of refugees, the freedom of the media and the conduct of free and fair elections.³⁴

Croatia has adopted a model of protecting national minority rights that, first of all, recognizes the existence of national minorities, and secondly, assures not only the cultural autonomy but the representation of national minorities at all levels of the state apparatus.

The first model of the protection of national minorities was introduced in 1997. It assured the preservation and development of (ethnic, cultural, linguistic and religious) identity for national minorities individually and in associations with all citizens, with an emphasis on joint efforts directed at stopping assimilation and ensuring the preservation of the diversity of the society.³⁵ In the period between the report in 1999 and the one in 2003, a lot of recommendations were adopted, and in that time a whole legal framework was created. There was a major improvement of the legal basis for the protection of minority rights and the right for own language and representation at all levels of the state apparatus. Besides the representation at all state levels, a special mechanism was introduced through the institutions of councils and representatives. The number of the representatives of the national minorities in the parliament also increased. However, many issues remained unresolved, such as the economic position and perspective of all citizens living in parts of Croatia where war had devastated the economic infrastructure, including members of national minorities. This is specifically related to the return of refugees, the return of their property, and employment.³⁶

The Opinion on the Report of the Republic Croatia on the Implementation of the Framework Convention on Minority Rights in 2004 showed that many steps were undertaken to implement the Framework Convention on Minority Rights and to strengthen the dialogue between the majority and the minority in the society. However, certain problems remained unresolved, such as the representation of the members of national minorities in the judicial system, the use of other languages at the local level, and 'the Roma question'.³⁷

By implementing the recommendations of the Framework Convention, Croatia has shown the determination to build an adequate model of protection according to the historical, cultural and national specifications of the country. The Constitutional Law on Human Rights

³⁴ Sinisa Tatalovic, *Nacionalne manjine u Hrvatskoj* (Split: Stina, 2005).

³⁵ Sinisa Tatalovic, "Model of Realization of Ethnic Rights of National Minorities in the Republic of Croatia," *Politicka misao*, vol. 34 (1997).

³⁶ Report of Republic Croatia on Implementation of Framework Convention of Minority Rights, Zagreb, 2004.

³⁷ Ibid.

and the Rights of National Minorities was a part of a set of political obligations taken in the framework of the Stabilization and Association Agreement, and therefore, an important stepping stone on Croatia's path towards a full-fledged membership in the EU³⁸. Extremely important for the European Commission was the general increase of minority representation in the local bodies, and especially the increase of the number of minority MPs at the state level from 5 in the year 2000 to 8 in the year 2003. Besides that, the fact that Croatia has ratified all conventions of the Council of Europe and has concluded bilateral agreements about the protection of minority rights with Italy, Hungary, Serbia and Montenegro was very well received, while the practice of the use of the language and the education of minorities was graded satisfactory. The special model of representation through councils and representatives at the local level was seen as very effective, with special focus on the importance of a better representation of the members of national minorities in public services. On the other hand, the European Commission was critical about the media and the lack of adequate programs on minority languages.

The Roma question was identified as one of utmost importance, and the European Commission welcomed the adoption of the National Program for the Roma in accordance with the "Decade of Roma Inclusion 2005-2015". Apart from that, the Serbs in Croatia, as the largest minority, have a special status. Therefore, the European Commission has pointed out the increase of the number of Serbs since the war, the return of refugees, as well as the return of their property. It is also important to notice that the government made a broad political agreement with the representatives of the Serbian minority in 2003 and put their representatives in high positions in the executive branch, which gave them the opportunity to positively influence the general position of their minority.³⁹

The important role in the protection of national minority rights is also thoroughly monitored by the OSCE. Apart from its generally positive evaluation, the remarks from the OSCE are mainly related to the representation of the members of national minorities in the judiciary system and the electoral lists that were not updated.⁴⁰ However, as it will be clear at the end of this section, a major proof of democratic maturity in the country, at least from the

³⁸ Sinisa Tatalovi, „Europski mehanizmi zastite nacionalnih manjina,“ in *Godisnjak Sipan 2004* (Zagreb: Politicka kultura, 2005).

³⁹ European Commission, *The European Commission opinion on the application of Croatia for membership of the EU* (Brussels, 2004), http://www.mvpei.hr/ei/Download/2004/04/27/Misljenje_EK-hrv.pdf.

⁴⁰ Status Report No. 15 on Croatia's Progress in Meeting International Commitments, 2004, http://www.osce.org/documents/mc/2004/11/3828_en.pdf.

perspective of this international organisation, is the fact that the OSCE has ended its mission in Croatia.

In conclusion, it is useful to remember that the OSCE, the Council of Europe and the European Commission have issued reports on Croatia's progress in the field of the protection of national minorities in the year 2007. These observations about changes related to the implementation of the Constitutional Law on National Minorities seem to be generally positive, with some remarks related to the slow changes in practice, the return of refugees and their property, the protection of the Roma and the integration of the Serbian national minority into the society. Perhaps the best way to assess the situation on these issues in Croatia these days is to quote a part of the Report of the Head of the OSCE Office in Zagreb, Ambassador Jorge Fuentes to the OSCE Permanent Council in 2008:

"The efforts and progress by Croatia in fulfilling OSCE commitments have permitted the culmination of a process that began almost 12 years ago when the Mission to Croatia was established in the aftermath of the armed conflict. The Mission has been a success for both the OSCE and Croatia and the final balance is quite positive. Croatia has proved to be a stable and maturing democracy, subject to irreversible and self-sustaining reform processes through its institutional and organizational framework. The processes for EU and NATO membership represent additional guarantees. Croatia's completion of most aspects of the Mission's mandate convinced the Permanent Council to close the Mission. Since further progress was warranted in relation to several mandate issues, notably the prosecution of war crimes, the PC established the Office in Zagreb.

The OSCE High Commissioner on National Minorities (HCNM) has indicated his continued engagement with the protection and promotion of rights of persons belonging to national minorities in Croatia, consistent with his engagement in all Participating States."⁴¹

According to the Progress Report of the European Commission in 2007, "...major progress in the field of protection of national minority rights is evident with remarks related to the implementation of Constitution Law on Minority Rights (CLNM) in practice, especially related to the action plan covering all state institutions concerned with CLNM. Problems persist, particularly in terms of under-representation of minorities in state administration, judiciary and police. Elections for the local councils of national minorities have showed progress in comparison to the 2003 elections but with a still low voter turn-out.

⁴¹ Organization for Security and Co-operation in Europe, *Report of the Head of the OSCE Office in Zagreb Ambassador Jorge Fuentes to the OSCE Permanent Council*, 2008, http://www.osce.org/documents/mc/2008/03/30456_en.pdf.

Protection of cultural rights of national minorities has been satisfactory with remarks to the representation of minorities in the media and bi-lingual rights guaranteed in municipalities and towns that haven't been adequately protected.”⁴²

One can conclude that Croatia, if we put aside the few aforementioned remarks, has developed a solid model of the legal basis and practical experience in the field of the protection of national minority rights, serving as a model for other countries in the region that are still facing severe difficulties in this field. By working hard on the recommendations of the international community and the elimination of the remaining ethnic tensions, mainly by the inclusion of the minorities into the Croatian society, it has managed to consolidate the mechanisms of minority protection, as well as its democracy in general, and continued successfully with the negotiations towards membership in the EU and NATO.

1.2.4 Religious freedoms

When considering religious freedoms in Croatia since the independence, it is important to mention that religion and ethnicity are closely intertwined, which makes it difficult to distinguish between ethnic and religious discrimination in those years. Religion as a term that connected to ethnicity led to violence, including the destruction of religious institutions during the war. Also, when mentioning the violent behaviour of the members of different nationalities, it is important to underline the fact that this behaviour was not based on religion, but it has been ethnically motivated during the past few years.

A comparison of the reports regarding religious freedom shows major progress regarding the process of the democratization of the society in this specific field. Therefore, it is useful to present some key observations from the U.S. State Department reports, as well from those of the European Commission.

According to the Religious Freedom Report of the US State Department, in 1999, the approximate religious breakdown of the country was: Roman Catholic 85 %, Orthodox Christian, 5%, Muslim 1%, Jewish 1%, atheist 3% and other 5%. The high percentage of Roman Catholics makes the Roman Catholic Church predominant in the society, especially taking into account its historic relationship with the Holy Seat and the great support to the Croatian independence it offered during the early 1990s. According to the report, the freedom

⁴² European Commission, Commission Staff Working Document 'Croatia 2007 Progress Report' Accompanying The Communication From The Commission To The European Parliament and The Council Enlargement Strategy And Main Challenges 2007-08, http://ec.europa.eu/enlargement/pdf/key_documents/2007/nov/croatia_progress_reports_en.pdf.

of conscience and religion and the free public profession of religious conviction is provided by the Constitution, and they are also respected in practice. In addition, these are some of its other findings: “There were no restrictions regarding conducting public services or opening charitable and social institutions. Religion training was provided in schools and it was optional for all religions if they fill the necessary quota. Unfortunately, due to the lack of resources and adequate teachers, the training is mainly offered in Catholic catechism. As a contribution of religious institutions regarding mainly ethnic issues in post-war society, churches have organized meetings with the intent of reconciliation, especially between the Catholic and the Orthodox Church”.⁴³

According to the Religious Freedom Report of the US State Department, in 2002, “There was no change in the status of religious freedom during the period covered by this report, and the democratic coalition government continued to contribute to the generally free practice of religion.”⁴⁴

It is indicative that the representatives of several minority religion groups have stated that the overall climate for religious freedom has improved since the 2000 election of the coalition government, meaning more media space for different religious communities. The issues of the restitution of the nationalized property has remained a problem for the major religious groups, mainly the Catholic, Orthodox, and Jewish ones. The period after 2000 is significant for the legislation adopted regarding the freedom of religion. In 2002, the Law on the Legal Status of the Religious Communities defined the legal position of the communities with regard to government funding, tax benefits and education.

According to the Religious Freedom Report of the US State Department, in 2006, the main changes were related to the legislation. “In 2003 Regulation on Forms and Maintaining Records of Religious Communities in Croatia was approved and it led to the registration of forty religious communities. Understanding of differences is very important for the social cohesion of the society, therefore media can make a great contribution. In Croatia in 2005, Croatian Radio Television (HRT) recognized that importance and signed an agreement with eight minority religious communities guaranteeing equal representation in its programs on weekly and monthly coverage and obligated to report on all the major celebrations. Other than that it is important to mention that Catholic Church operates one of the private radio

⁴³US State Department, *Croatia - International Religious Freedom Report 1999*, http://atheism.about.com/library/irf/irf99/blirf_croatia99.htm.

⁴⁴ US State Department, *Croatia - International Religious Freedom Report 2002*, <http://www.state.gov/gov/d/rls/irf/2002/13926.htm>.

stations. Regarding religious holy days, Muslims have the right to celebrate their holy days and they are granted a paid holiday for one Bairam day⁴⁵. The report mentions schools organized for members of the minorities, including a Jewish private school, an Islamic secondary school, an Orthodox secondary school, with plans for university levels, as well as the restitution of property as a remaining problem in this period, too.

The Catholic Church has had a great influence in the society, advocating traditional values. For instance, in 2005 the Church publicly criticized the international Global Fund's MEMOAIDS, which was designed to raise awareness about the importance of the use of contraception, especially among the youth. On the other hand, the church works hard on ethnic and religious reconciliation. It is also worth adding that according to surveys, the institution that people have most trust in is still the Church. Also, in the light of contemporary trends in the relations between Islam and Christianity, it is important to underline that Croatia is one of the four countries in Europe that fully recognize Islam, and where the Muslim society has been successfully integrated into the society.⁴⁶ This represents a promising potential for the further enhancement of Croatia's relations with the Islamic world, which has shown some results in the last years. In its conclusion, the US State Department report states the following: "During the period covered by this report, human rights nongovernmental organizations (NGOs) and religious leaders noted that overall ethnic and religious relations remained stable."⁴⁷

Owing to the importance of the EU's evaluation of Croatia's overall democratic progress, it is important to take into consideration the European Commission's Commission Staff Working Document Croatia 2007 Progress Report, which also generally confirms that the freedom of religion is guaranteed in Croatia. Therefore, only a small part of the report deals with this issue, saying that "There have been no particular difficulties as regards the freedom of religion."⁴⁸

⁴⁵ US State Department, *Croatia - International Religious Freedom Report 2006*, <http://www.state.gov/g/drl/rls/irf/2006/71374.htm>

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ European Commission, Commission Staff Working Document Croatia 2007 Progress Report Accompanying The Communication from the Commission to the European Parliament and The Council Enlargement Strategy and Main Challenges 2007-2008, {COM(2007) 663 final}, 2007, http://ec.europa.eu/enlargement/pdf/key_documents/2007/nov/strategy_paper_en.pdf.

1.2.5 Media freedoms

The mass media in Croatia during the 1990s experienced dramatic challenges. Although the fall of the communist regime led to increased freedom of the press, the development of the press at that time experienced many difficulties. According to the Nations in transit 1999-2000 Report on Croatia, which illustrates the media freedom in Croatia during the 1990s, "...freedom of expression and press is guaranteed by the Constitution. Journalists can be prosecuted for insult and defamation. The New York-based Committee to Protect Journalists reported in 1998 that there were 300 criminal proceedings against journalists and more than 600 civil suits against newspapers, mainly *Globus*, *Nacional*, *Feral Tribune* and *Novi list*. The Law on Telecommunications and Post assured a monopoly for the Croatian Radio-Television (HRT), which, on the other hand, served as a tool for President Tudjman's campaign and authoritarian regime. In the nineties a number of independent radio and television stations were closed. Monopoly in newspaper distribution was mainly given to *Tisak*, a company close to the HDZ establishment. The Freedom House's annual Survey of Press Freedom rated Croatia "Partly free" from 1994 through 1996 and "Not free" from 1997 through 1999."⁴⁹

In the meantime, after the 2000 democratic changes, significant efforts were invested into changing the position of the media in the Croatian society. Major efforts were directed towards the reform of Croatian Television, which has managed to become an ordinary public television, after being a PR agency of the political elites during the 1990s. This progress was recognized in the EU, and according to the European Commission's Working Document, the Croatia 2007 Progress Report, the freedom of the press in Croatia is seen as follows:

"Freedom of expression including freedom and pluralism of the media continue to be provided for in Croatia. Some progress has been made in following up the recommendations of the 2004 joint expert mission for changes to the laws on electronic media and on Croatian radio and television. Following a renewed public tender, parliament appointed the remaining four members of the State news agency HINA management board. However, the public broadcaster HRT continues to be subject to occasional political pressure, raising concerns

⁴⁹ United Nations, *Nations in Transit 1999-2000: Country Report of Croatia*, <http://unpan1.un.org/intradoc/groups/public/documents/nispacee/unpan008362.pdf>.

about freedom of expression. There are possibilities for undue political influence on the media at the local level, with much of the media at this level in public hands.”⁵⁰

Taking into consideration the developments since 2000 and the messages from these reports, it is obvious that recognisable progress has been made in the last decade, but also that there is room for further improvement.

1.3 The functioning of the Parliament and parliamentary control

1.3.1 The evolution of the parliamentary practice in Croatia

As it was already mentioned, the legal basis of representative governance is drawn from the concept of inseparable national sovereignty. Therefore, if the sovereignty belongs to the nation as an abstract constitutional subject, and it is regarded as something that consists of not only contemporary but also past and future generations as well, it is obvious that governance cannot be conducted by its every single member or by the nation as a whole. Therefore, modern democracies recognise the institution of the representative body (the parliament) as a legal expression of the will of the nation, which is given legitimation at the parliamentary elections that are conducted every four years.

As it is the case in all other modern democratic systems, the Croatian constitution recognises the principle of national sovereignty, understanding ‘nation’ as a comprehensive term that includes all Croatian citizens, regardless of their ethnic, religious or any other differences.⁵¹ Owing to the fact that, according to Article 1 of the Croatian Constitution, the nation exercises its power by electing its representatives, it is obvious that the concept of representative governance is accepted, and in line with that, the Constitution (Article 70) clearly states that the Croatian Parliament is a representative body of the Croatian citizens as well as the main body of the legislative branch in the country. According to the 1990 Constitution, the Croatian parliament had a bicameral structure, and it consisted of the House of Representatives and the House of Counties, where the first one used to hold all the authorities of a parliament, while the other represented a form of regional representation.

Regarding the discussion about the role of the parliament and its relations with the other branches of power at that time, it is useful to mention that the Croatian president had the right for a life-long seat in the House of Counties after the expiration of his presidential

⁵⁰ European Commission, *European Commission’s Working Document - Croatia 2007 Progress Report*, http://ec.europa.eu/enlargement/pdf/key_documents/2007/nov/croatia_progress_reports_en.pdf.

⁵¹ The Constitution of the Republic of Croatia, Article 1.

mandate. Apart from that, he had the so-called 'virile right', which was characteristic of pre-modern electoral history and represented the right to individually appoint several persons to the representative body and thus influence its structure and the political relations within it. According to the 1990 Constitution, the president was entitled to name five representatives to the House of Counties, through whom he used his position to strengthen the absolute majority of his party in it.

This is only one of a number of examples that the functioning of the Croatian parliament in the first decade of the post-communist transformation was conducted in a paradoxical way. While the enormous symbolic importance of the Croatian parliament was almost unquestioned, its real political importance was somewhat different, and it was marked by the marginalisation of its position in the political system, especially in relation to the dominant executive branch, which manifested in the position of the country's president, as well as to some non-institutional political subjects, such as political parties, security services, and informal interest groups.

The significant symbolical importance of the Croatian parliament is derived from its historical role of the 'guardian of the Croatian sovereignty', owing to the fact that during the centuries, regardless of the wider political frameworks that Croatia was part of (the Habsburg Empire, the Austro-Hungarian Monarchy, the Kingdom SHS, the communist Yugoslavia), it represented the main institutional guarantee of the independent political life. In general, that was frequently used as a proof of the continuity of the Croatian municipal right, as well as the basic argument for the right to form a modern Croatian nation state.⁵²

However, the development in the 1990s shows the evolution from a complicated representative body during communist times, followed by a marginalised representative body with limited functionality in the era of the dominant executive branch, to a better structured and functional unicameral representative body after 2001, which represents a recognisable political counter-balance to the executive branch in the new parliamentary system. In fact, the bicameral structure of the parliament introduced with the 1990 Constitution was questioned from the very beginning of its existence, mainly because of the fact that its essential part of defending regional representation and decentralisation was rather questionable in the unitary state of Croatia in the 1990s. Apart from that, during its two mandates, the House of Counties in its praxis mainly followed the interests of the party in power (HDZ), and instead of representing the regional interests regardless of the political characteristics, it acted as a

⁵² As it was mentioned in the first chapter (p. 11-12), this symbolic importance is incorporated in the Preamble of the Croatian Constitution, representing a basis for the proclamation of independence.

second-class representative body, i.e. the copy of the first house, with less authority and fewer responsibilities. In short, it was not only that the bicameral structure was not in line with the Croatian parliamentary tradition⁵³, but the House of Counties simply did not function as an effective representative body, either. Furthermore, its existence significantly complicated and slowed down the procedure of decision-making in the parliament, which negatively affected the already weak position of the legislative body *vis-à-vis* the strong executive branch personalised in the institution of the President of the Republic.

As it was already mentioned, the legal and political position of the President of the Republic was among the most controversial issues of the Croatian political system in the 1990s. During the period of drafting the 1990 Constitution, the need for a powerful institution of the president in the semi-presidential political system was based on the argument about the specific environment in which the country started its state-building process, which was marked by turbulence, armed conflicts, and which required functional and stable authorities, which cannot be achieved with a purely parliamentary system characterised by a fragmentation of the party system, instable parliamentary majorities and very weak governments.

The constitutional conception of governance was formulated mainly according to the understanding and preferences of the first Croatian president, who was, owing to the clear majority with which his party won in the 1990 elections, in a position to significantly influence the main determinants of the constitution. In accordance with his 'degaulleistic perception' of politics, marked by beliefs related to the historic roles of national leaders in the process of state-building, the first Croatian constitution was characterised by a dominating presidential position, with competences for individual decision-making on the important political issues. Furthermore, the populist nature of HDZ, which used to function more as a movement than as a party, required a leader in a traditional sense, whose undisputed authority would have an integrative effect on the different factions within the movement and prevent its dissolution.

Despite the fact that the constitution itself provided the president with a significant amount of power, such as the right to appoint and dismiss the president of the government and its members, the right to issue legislations with the power of law in extraordinary circumstances and many others, the prevailing interpretations of the accumulation of power in the hands of the president during the 1990s tend to find the main reasons for that in a

⁵³ Throughout history, the Croatian parliament had always been unicameral.

combination of the above-mentioned constitutional provisions and the environment as well as the manner in which the governance was conducted. During the entire time he was in office (1990-99), President Tudjman could rely on the undisputable parliamentary majority of the party, where he preserved his position of unchallenged leader.

Apart from that, he established a parallel mechanism of presidential bodies and advisers, which were functioning *de facto* as the highest decision-making bodies, responsible only to the president.⁵⁴ Apart from that, as it was partially mentioned before, the complexity of the bicameral parliamentary procedure, combined with the extreme conditions in the period of aggression and the occupation of a significant part of the country, created a situation where the executive branch (especially the president) had a clear political initiative. Furthermore, their dominance in that period was clearly visible from the fact that during the first few years, a large number of laws and regulations were adopted using the so-called ‘emergency procedure’, which dramatically narrowed down the time and the possibilities for the discussion of the respective issues in the parliament, and hence, marginalised the role of the representative body, not to mention any form of parliamentary oversight, which would be typical for developed democracies.

1.3.2 The New Constitutional Arrangement

These were the main reasons for the constitutional changes at the beginning of this decade, which followed the political changes in 2000 and marked a new beginning in Croatia’s political life, and a new dynamics in its relations with the Euro-Atlantic community. One of the main characteristics of the new constitutional setting is the transformation of the political system from a semi-presidential to a parliamentary one, with a dramatically lower authority of the president *vis-à-vis* the prime minister within the executive branch, as well as the improved position of the legislative branch, i.e. the new unicameral parliament.

1.3.2.1 Parliamentary committees

The working bodies of the parliament are undoubtedly among the most important mechanisms of the functionality of the parliament and its oversight of the executive branch. Their structure, number, and competences are determined in the Rules of procedure of the Croatian parliament. The so-called parliamentary committees were formed in order to ensure

⁵⁴ See details on this issue in the next section, which deals with the political power relations.

a debate on specific topics before the final parliamentary procedure, as well as the preparation of materials for the plenary sessions. However, the fact that they are field-oriented gives them a kind of legitimacy to influence or at least to shape the final decision in the parliament, which also makes the parliament itself more legitimate and efficient in the decision-making process *vis-à-vis* the executive branch on the given issue, and hence, to a certain extent, this contributes to its oversight of the political system in general.

The Croatian parliament has twenty-four working committees and a Board for Mandates and Immunity. When analysing their competences, one can conclude that a significant number of these corresponds to the government's different fields of activities (the Committee for Agriculture and Forestry, the Committee for Finance and State Budget, etc.), while some follow the logic of parliamentary work (the Committee for the Constitution, the Rules of Procedure and the Political System, the Committee for Applications and Complaints, etc.), or they concentrate on important and specific fields (the Committee for Gender Equality, the Committee for Human Rights and the Rights of Minorities, etc.).⁵⁵

Owing to the changing international environment marked by integration processes and the new dynamics of both the domestic and the foreign policy, as well as to the significant increase of the importance of the parliament in Croatia's political system after the constitutional changes, this representative body assumes more competences and responsibilities, which requires a division and specialisation of labour and responsible decision-making, where the role of the parliamentary committees becomes more visible. One may conclude that the parliamentary committees have an extraordinary significance in this constellation, especially with regards to the specific relations between the legislative and executive branches. In order to provide the reader of this study with a general picture of the parliamentarian committees' competences, their full list can be found below.

- Committee for Constitution, Rules of Procedure and Political System;
- Committee for Legislature;
- Committee for Foreign Policy;
- Committee for Interior Policy and National Security;
- Committee for Finance and State Budget;
- Committee for Economy, Development and Reconstruction;
- Committee for Tourism;

⁵⁵ Generally, the committees consist of MPs, and their structure depends on the political consensus of the position and opposition. However, in some cases, the members are not MPs, but experts or members of some interest groups (syndicates).

- Committee for Human Rights and Rights of Minorities;
- Committee for Judiciary;
- Committee for Labour, Social Policy and Public Health;
- Committee for Family, Youth and Sports;
- Committee for Immigration;
- Committee for War Veterans;
- Committee for Physical Planning and Environmental Protection;
- Committee for Education, Science and Culture;
- Committee for Agriculture and Forestry;
- Committee for Maritime Affairs, Transport and Communications;
- Committee for Selection, Appointments and Administrative Services;
- Committee for Applications and Complaints;
- Committee for Inter-parliamentary Co-operation;
- Committee for European Integration;
- Committee for Informing, Informatisation and Media;
- Committee for Gender Equality;
- Committee for Local and Regional Self-management;
- Board for Mandates and Immunity.⁵⁶

1.3.2.2 Other forms of parliamentary control over the activities of the government

Besides the typical legislative competence (i.e. the adoption of laws), the Croatian parliament has authority over the confirmation of international treaties (ratification) concluded by the representatives of the country's executive branch with international partners. Taking into consideration the fact that international treaties are not considered to be enacted until they are ratified in the parliament, it is obvious that this form of confirmation gives a power of oversight over the executive branch's conduct of foreign policy to the representative body.⁵⁷

Apart from the fact that, like in any other parliamentary system, the representative body appoints and dismisses the government, there are some other mechanisms that ensure its oversight over the executive branch. One of these is MPs' right to question the members of the government during the so-called 'actual morning session', which is regularly conducted at

⁵⁶ Rules of Procedure of Croatian Parliament, Article 56 (Croatian), www.poslovniforum.hr/zakoni/poslovnik_hrvatskog_sabora.asp.

⁵⁷ An excellent example for this is the so-called Border Agreement with Slovenia, which was signed by the prime minister but never ratified in the parliament, and hence, it was never considered relevant.

the beginning of every parliamentary session. There are two forms of question that an MP may direct to the members of the government – oral or written ones. The first form is mainly used during the above-mentioned ‘actual morning session’, while the second one can be directed to the members of the government any time. The members of the government are obliged to respond to the MPs’ questions in an appropriate form, according to the Rules of Procedure of the Croatian Parliament.

Another mechanism is the right for interpellation, which is in essence similar to the right to question the members of the government because the question is raised from the side of the parliament and requires a response from the government’s side. However, it differs from the previous mechanism at least in two details. First, the right for interpellation is regularly given to a group of MPs, while the right to question the government belongs to each MP individually. Second, in the case of interpellation, a discussion in the representative body follows the government’s response, which may be a subject of voting in the parliament as a form of evaluating its quality or MPs’ satisfaction with it.⁵⁸

Also, according to Article 91 of the Croatian Constitution, the parliament may exercise the oversight of the government, i.e. the entire public administration, with its special boards for investigation, which have the right to question and investigate certain activities of the government and the public administration. In the parliamentary practice in different countries, these boards very often act as hearing boards or some form of special courts for state officials and employees.⁵⁹

One can conclude that significant political changes have taken place in the Croatian political system during the last decade. These changes have had a positive impact on the transitional reform process on the country’s path towards its place in the Euro-Atlantic structures. Croatia has drastically changed its reputation and general image in the international community, which has been confirmed on several occasions. The specific consequences of these will be assessed in the pages to come.

Bearing in mind the information about ‘the sovereignty holder’ in any modern republic, we can say that all these changes would have no significance if they were not ‘for the people’. Therefore, it would be interesting to see the attitude of the Croatian citizens

⁵⁸ The right for interpellation was introduced in the 2000 Constitution as one of the innovations in the framework of changing the political system from a semi-presidential to a parliamentary one.

⁵⁹ While the praxis in Croatia on this matter is still in the developing phase, these kind of boards are very well known in countries like the US and France.

towards the national political institutions, as well as towards the international ones, in comparison with the attitude of European citizens.

Table 1.7 Trust in institutions

	TENDS TO BELIEVE		TENDS NOT TO BELIEVE		DOES NOT KNOW	
	EU 27	CROATIA	EU 27	CROATIA	EU 27	CROATIA
GOVERNMENT	34%	20%	59%	75%	7%	5%
PARLIAMENT	35%	20%	56%	75%	9%	5%
DOMESTIC JUDICIARY	47%	14%	46%	79%	7%	7%
EUROPEAN UNION	48%	32%	36%	57%	16%	11%
EUROPEAN PARLIAMENT	55%	40%	27%	41%	18%	19%
EUROPEAN COMMISSION	50%	39%	26%	41%	24%	20%
COUNCIL of the EU	44%	41%	25%	40%	31%	19%
EUROPEAN CENTRAL BANK	47%	34%	24%	38%	29%	25%
UNITED NATIONS	53%	39%	30%	49%	17%	12%
POLICE	64%	45%	31%	50%	5%	5%
ARMY	71%	59%	19%	33%	10%	8%
RELIGIOUS INSTITUTIONS	46%	55%	42%	39%	12%	6%
SYNDICATES	39%	35%	45%	53%	16%	12%
POLITICAL PARTIES	18%	8%	75%	86%	7%	6%
CONSUMERS' UNIONS	65%	54%	22%	31%	13%	15%

Source: Country Report - Croatia, EUROBAROMETER 68, Autumn 2007 – http://ec.europa.eu/public_opinion/archives/eb/eb68/eb68_hr_nat.pdf

It can be seen from Table 1.7 that the general trust of the Croatian citizens in national institutions is still rather low in comparison with that of the European citizens. However, despite their traditional scepticism, there is an obvious increasing trend if we take into account the surveys from past years, which have shown minimal percentages in these categories. On the other hand, the sign of traditionalism can be traced in the relatively high confidence in the army and religious institutions, which seems to be the only category that is above the 50% margin. It is expected that the confidence in domestic institutions will rise in parallel with the country's progress on the track to a membership in the Euro-Atlantic community, mainly because it assumes the increase of these institutions' transparency and functionality. Nevertheless, we should not underestimate the fact that this progress assumes taking more difficult steps in the final stage of the transition process, which includes unpopular measures that have to be taken by the national government at home. This complex of relations may significantly decrease the popularity of both the national and the European

institutions, as it was the case in the majority of the former transitional countries, so these effects should not be excluded in the analysis of the Croatian data, either.

1.4 The restructuring of the political power relations (confrontations and consensus-building)

1.4.1 Political power relations in the former Yugoslavia

In order to understand the political power relations in Croatia during the 1990s and today, it is very important to take a look at the structure and praxis of these relations in the former federation. This one may find helpful when trying to assess whether there was any tradition of power sharing that may be useful for a consensus-oriented political behaviour or culture in the contemporary society of the country.

The general societal system of the former Yugoslavia, together with its subsystems (political, economic, etc.), may be regarded as an example of an inseparable monolithic mechanism, organised on the principle of a revolutionary-quasi-democratic hierarchy, where the lower instances absolutely and uncritically obey the order of the higher ones. At the top of the pyramid there was the Politbureau of the Central Committee of the Communist Party of Yugoslavia, which consisted of approximately a dozen persons, who were responsible for running the country and every segment of the society. Their members were in charge of the particular parts of the system, which was divided into sectors and based on a general state monopoly over the production assets.

This general description of the system reveals that its structure was built as a replica of the internal organisation of the communist party. Despite the fact that the political system was based on the principle of the so-called representative democracy, the power *de facto* belonged only to the party elites. Therefore, the representative bodies had a marginal role in the political system and were no threat at all for the party elites' monopoly in the decision-making process, and in fact, they served only for the acclamation of the policy proposals, giving them formal legitimacy. Apart from that, below the level of the party leadership, there was a huge and mighty apparatus whose role was to ensure that the leaders' decisions would be implemented in practice. Following this path of state-building, within a very short period of time the general societal structure transformed dramatically into an etatistic one and after only few years there was no field of societal life that had not been 'covered' by some form of supervision by the state.

However, no matter how rigid the system was, it could not be immune to its internal and external challenges. Up to the early 1970s, the situation in Yugoslavia and in its international surroundings changed, and they started challenging relations within the federation and its political structure. The unresolved national question, which had been swept under the carpet of the ‘fraternity and unity’ myth for some time, linked with the issue of the power relations between the republics and the institutions of the federal state, raised some existential questions about the future of the federation.

A return to the Soviet-style centralism was not feasible, owing to the fact that it would represent a form of the rejection of the already developed ‘Yugoslav type of socialism’ - marked by the resistance to Stalin in 1948, socialist self-management, and the non-alignment movement - and a step back to the Eastern bloc. On the other hand, the fact that the republics were already in a Cold War – a state of permanent confrontations, where their leaders gathered at federal level meetings without any fruitful discussion or confidence in each other – any form of unity or common vision of the Yugoslav federation was difficult to envisage. In a constellation like this and since dissolution was not an option in the international environment of the 1970s, the national communist elites decided to continue with their national policies, preserving the common state by relying on the only two remaining integrative elements of the federation – President Tito and the Federal Army.⁶⁰

Taking into account the fact that even these two elements were not as powerful as they used to be before, the constitutional changes that introduced very ‘elastic bonds’ between the republics seemed to be the only option for the preservation of Yugoslavia. Loose confederalist institutional solutions, combined with the mentioned system of a ‘socialist self-government’, which was incorporated into the 1974 Constitution, dramatically changed the power relations within the state. Furthermore, the introduction of, for example, the right of self-determination for each nation represented *de facto* the beginning of an end for the Yugoslav federation, owing to the fact that it was used as the constitutional basis for the proclamation of the independence of the ex-Yugoslav republics in the early 1990s.

Therefore, we may say that several different models of power relations were seen during the approximately fifty years of communist Yugoslavia. However, none of them proved to be good enough to neutralize the unbridgeable differences within the federation and prevent dissolution in the early 1990s. Apart from the many differences, there is at least one thing that was in common for former Yugoslavia, and that is its communist system, which

⁶⁰ For details, see Dusan Bilandzic, *Hrvatska moderna povijest* (Zagreb: Golden Marketing, 1999).

was, regardless of its models, monolithically organised and hostile towards any form of power sharing in its modern understanding. Therefore, despite the fact that Yugoslavia was frequently used as an example of a 'not that rigid' system, especially in comparison with the other former communist European states, it has to be stressed that it was a one-party state with the undisputable monopoly of the communist party over the political system and the society in general, and therefore, it definitively does not represent a desirable tradition for a consensus oriented power sharing behaviour in the contemporary Croatian political system, which was especially visible during the 1990s.

1.4.2 Political power relations during the 1990s

Unlike in the period of the absolute dominance of the Communist Party, political parties are essential subjects of a modern democratic political process, since their activities and the relations among them largely determine the institutional structure of the political system and the formal procedures of the decision-making process. Furthermore, it has to be underlined that the institutions in democratic countries derive their legitimacy from the legitimacy that the political parties earn in the election process. Therefore, for a very long period of time, the multi-party system has represented the main 'institution of mediation' between the society and the state, i.e. between the citizens and the government.

The formation of parties in new transitional countries undoubtedly represents a special phenomenon, especially with regard to their significance for the process of democratic consolidation. Namely, unlike in the political processes in the South European countries a few decades ago (Greece, Spain, Portugal), where the transition began with the reanimation of the old political parties, in the case of the ex-communist states, the parties emerged only in the late 1980s. This happened due to three main reasons:

- In most countries there was no pre-communist pluralist political tradition, or it was very weak and unstable;
- In the case of the appearance of a pluralist transition, if any, communism was dominant for long enough to neutralise them;
- Communism did not tolerate the existence of new political parties.⁶¹

⁶¹ For details see Mirjana Kasapovic, *Hrvatska politika 1990.-2000.* (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2001), 122-123.

The first political parties in Croatia were formed in 1989 and 1990, mainly as clubs of intellectuals, public persons and former political dissidents, who gathered in order to offer 'an alternative option' to the existing political reality. Among all of them, only HDZ managed to develop a broader organisational structure with solid material support within the country and especially abroad, ensuring the significant increase of its membership and other preconditions for being able to take the decisive role in the country's political life during the 1990s. First of all, using the pressures from the Serbian political elites and the historical momentum of the collapse of communism, the HDZ managed to go beyond the form of a simple political party and became a much wider movement, advocating the end of the communist regime, and Croatian independence and sovereignty. As it was mentioned before, owing to its political character, which inclined more to populism than to liberal-democracy, it did not dissolve after the formation of the multi-party system, like it was the case in Poland, and Slovenia. On the contrary, it remained in power using different semi-authoritarian means to govern the country undisputed, marking the difference between the transitional processes in Croatia and other post-communist countries.

In general, when speaking about power sharing, the model of the absolute domination of one party known from the political praxis of the former federation *de facto* did not change dramatically. Broadly speaking, the model of one predominant party marked the whole ten-year period between 1990 and 2000. First of all, there was the great advantage of the party in power compared to the second strongest one, in terms of the outcome of the elections. This difference increased significantly in the parliament, owing to the disproportional effect of the majority electoral system, so the HDZ had six times more MPs than the second strongest party.

Other mechanisms of the institutionalisation of the HDZ as a movement were visible in the political vocabulary that was predominant at that time. The terminology of the nationalistic movement, together with its interpretation of the political reality and the promotion of its political goals under the influence of a media dominated by the political elites, appeared in almost every aspect of the public debate. As it was emphasized before, the position of the president, along with his constitutional position and his personality, which had been carefully built by the party support mechanisms, significantly contributed to the institutionalisation of the HDZ, and the general atmosphere of populism and clientelism, which replaced nationalist enthusiasm, only added to it.

On the other hand, while it is a fact that a single party dominated the political life in Croatia during the 1990s, the rift between a more organised opposition and the party in power

became very visible in the period between 1995 and 2000. The main reason for that was the end of the aggression and the occupation of a significant part of the country (1995), which practically ended the period of extreme circumstances and opened the floor for a debate on the democratic future of the country. While the war, apart from its well-known horrifying consequences, provoked broad national solidarity for the defence, and sometimes it served as a good excuse for the irregularities in the political and economic system, its termination opened opportunities for the reformulation of the political discourse in Croatia.

As a reaction to the above described environment marked with populism and clientelism, the opposition parties started to gather and oppose the regime instead of opposing each other, which had been the praxis for some time. This contributed to a perception of a 'united opposition' and a clear rift between the opposition and the government. This provided the 2000 election process with a new dimension of real competition and contributed to some new trends of power sharing.

1.4.3 The era of coalitions (2000 – present)

The 2000 elections marked a crucial turning point in the contemporary political life in Croatia. It not only represented the end of the era of a semi-autocratic regime in an isolated country, which had lasted for ten years, but also the beginning of an era of coalitions, which characterises the country. The significance of this trend for the democratic maturity of the political system seems to be self-explanatory, owing to the fact that it contributes to the development of a consensus-based decision-making practice, and hence, to the development of a consensus-oriented power sharing tradition. It is important to mention that this sort of change becomes even more important if we take into consideration the way power sharing, if any, had been conducted in the 20th century.

As a result of the progressive legitimacy crisis of the HDZ at the end of the 1990s, which was marked by inter-party rifts and the formation of factions, the rise of a broad public dissatisfaction with the relatively low standard of living, shady privatisation, a high unemployment rate, corruption, and the consolidation of the parliamentary opposition into two main coalitions (SDP and HSLs; and HSS, LS, HNS and IDS),⁶² which formed a government after the elections, Croatia began a new period in its democratic transformation.

⁶² SDP – Social Democratic Party; HSLs – Croatian Social Liberal Party; HSS – Croatian Peasants Party; LS – Liberal Party; HNS – Croatian People's Party; IDS – Istrian Democratic Union.

Therefore, after the fourth parliamentary elections in January 2000, for the first time in its modern history, Croatia faced a need for the creation of a coalition government.⁶³ The general conditions for such an endeavour were rather favourable due to the fact that the number of parties that were potential coalition partners was not too big.⁶⁴ Although the general conditions were favourable for the creation of a coalition government, the political-cultural framework was not, due to the fact that Croatia did not have any experience with this sort of government formation. Even the government of the Democratic Unity (1991 – 1992) cannot be regarded as a coalition government but rather as a war-time all-party government, which was highly dependant on the HDZ parliamentary majority and the president of the republic in a semi-presidential political system, based on the consensus of all political parties about a need for political unity for the sake of the defence of the country. It was not only that the political actors were not prepared for this endeavour, but even the public political discourse misinterpreted the political negotiation and the efforts to reach a compromise as examples of ‘political trade’, or ‘bargaining among parties’.

The experiences of developed democracies led to the conclusion that coalition agreements are becoming more detailed and lengthy, which indicates the need of the parties to thoroughly determine the elements of their co-operation, as well as the main figures of the future power sharing. This also shows that coalition agreements no longer represent only general political declarations, but they are rather detailed policy documents. The first Croatian coalition, made up of the six parties from the above-mentioned two coalitions, was formed on the basis of a few-page document, which lists very general goals of the government, such as the transformation of the semi-presidential political system, decentralisation, the development of an independent judiciary, and the depolitisation of the police and the army. Kasapovic presents a few examples that prove how general and under-developed the framework of the coalition policy was:

“It was not mentioned that in the framework of reform of the political system from a semi-presidential to a parliamentary one, the parliament itself will be reformed. Only in the second phase of the constitutional reform in 2001, was the House of Counties abolished and the Croatian Parliament did become unicameral. This was a change of utmost importance for

⁶³ Mirjana Kasapovic, “Koalicijske vlade u Hrvatsko – prva iskustva u komparativnoj perspektivi “ in ed. Goran Cular, *Izbori i konsolidacija demokracije u Hrvatskoj* (Zagreb: Biblioteka Politicka misao, Fakultet politickih znanosti, 2005).

⁶⁴ The rifts between the parties and new factions that appeared in the parliament had a significant impact on the parliament's work, while the split within the HSLs and its withdrawal from the government directly influenced its stability.

any democratic system that has to be mentioned in a list of priorities of the government. In the field of economic policy, two projects of the government that proved to be the financially most demanding and politically most successful ones (Highway Zagreb and the Split and government-supported housing program) were not mentioned at all.”⁶⁵

Furthermore, from the standpoint of a minimal winning coalition theory, whose ratio is derived from the maximisation of the profit of its members, this coalition was irrational owing to the fact that it consisted of more parties than needed, which decreased the political profit of the main winners of the elections (SDP and HSLs), increased the expenses of the negotiations and the decision-making process, as well as the potentials for conflict within it. This proved to be almost disastrous for the coalition, owing to the fact that due to the political differences, IDS left the government in the very beginning, followed by the faction of the HSLs during the middle of the mandate.⁶⁶

After the elections, a Coalition agreement on the formation of the government and the management of the House of Representatives was concluded. According to that agreement, a main conflict-resolution body was established, the so-called Co-ordination of the Coalition, consisting of the presidents of the parties that were part of the government. This body was *de facto* a consequence of the political agreement, in which only two party presidents took a post in the government, which resulted in complaints about the lack of information on the government’s activities by those who were not part of it. The co-ordination of the Coalition represented a compromise that should have resolved the situation, but it appeared not to be the best solution for the governing coalition because it was very unpopular among the public, and it was treated as a parallel structure or an informal body that has taken over the decision-making competences from the legally elected government.

The basic power sharing in the coalition was conducted according to the share of each party in the parliamentary mandates, so SDP was given 50%, HSLs 25%, and the other four parties shared the remaining 25%. The most important positions in the government (the Prime Minister, two Vice-presidents of the government, the Minister of Foreign Affairs, the Minister of Interior and the Minister of Finance) were given to the SDP, while the place of one Vice-president of the government and the Minister of Defence belonged to the HSLs. With that, the rule according to which the most important positions shall be given to the strongest parliamentary parties seemed to be obeyed. Apart from that, the rule of mutual

⁶⁵ Ibid, p. 198–99.

⁶⁶ The insufficiency of the coalition happened to be crucial for the survival of the government, owing to the fact that despite the loss of support from ten MPs, it managed to retain the parliamentary majority.

control within some ministries was agreed upon, which was reflected in the fact that the ministers were generally not from the same party as their assistants and state secretaries. Furthermore, another criterion was applied in the power sharing process in that parties assumed responsibilities in accordance with their nature. Thus, HSS, the Croatian Peasants Party, as almost all agrarian parties in European coalitions, was given the post of Minister of Agriculture and Forestry, the SDP was given the post of Minister of Labour and Social Welfare, and HSLS, as any other liberal party, took the place of Minister of Economy.

The first coalition managed to retain its relative stability and, despite a very troublesome political and economic environment, avoided early elections and remained in office for its full mandate. This experience was crucial as a starting point for future consensus oriented power sharing endeavours, and this is the reason why so much space has been dedicated to it in this study.

The 2003 elections showed the consequences of the malfunctions of the previous coalition and brought HDZ back to power. However, the need for a coalition was more than obvious, due to the fact that HDZ, despite its clear victory, was not able to form a government alone. Unlike in the case of the former coalition, the process of the creation of the government was not determined by the formal pre-elections agreements, although it was more or less clear who could be a partner in a HDZ-run government. It may be useful to warn about the political significance of the term ‘a HDZ-run government’, which reveals the dominance of the HDZ and a difference between the two coalitions. Namely, while the number of MPs in the parliament and the fact that in the government that was formed in 2003 only one post was not held by the HDZ, legitimises the term ‘a HDZ run government’, the same power sharing parameters of the previous government that were mentioned before (50% - SDP; 25% - HSLS; 25% - HSS, LS, HNS, IDS) show something entirely different. This difference had a significant impact on the efficiency of the government – it decreased the expenses of the negotiations and the decision-making process, as well as the potentials for conflict within it, while the position of the ‘strong prime minister’, who was the HDZ president at the same time, only contributed to this even more.

Immediately after the elections, five parties (HDZ, HSS, HSLS, HSP⁶⁷ and DC⁶⁸) participated in the negotiations; however, only one formally became a part of the coalition with HDZ. HSS withdrew from the negotiations, calling upon unbridgeable political and

⁶⁷ HSP – Croatian Party of Rights, the only remaining typical right-wing party.

⁶⁸ DC – Democratic Centre, the moderate faction of the HDZ, led by a former Foreign Minister and adviser to the former President.

economic differences, although according to numerous interpretations, it had done so because of the fear that the party might end up being swallowed up by a bigger one with a very similar ideology and overlapping target groups within the electorate. HSP was *de facto* excluded as an option, owing to the very negative reactions from the international community and the EU in particular regarding the possibility to include an extreme right party into the new government in a period when the country expected the *Avis* and a candidate country status. After HSLS decided to withdraw from the negotiations, only one partner, the DC, signed an agreement with HDZ, taking responsibility for a very unpopular post - the judiciary, which was in charge of the co-operation with the ICTY.

Formally, a minority coalition government was formed, with only 44.1% of the seats in the parliament. In fact, it was supported by an absolute parliamentary majority, ensured by a number of political agreements that were concluded between the HDZ and three HSU⁶⁹ MPs, two HSLS MPs, one HDSS⁷⁰ MP, and eight representatives of national minorities, including three members of the Serbian minority, which had a positive impact for the legitimacy of the government abroad. In this context, it is important to underline the difference between the coalition agreement and the bilateral political agreement that followed and ensured the parliamentary support for the government. The political agreements did not have the political significance of the coalition ones, so the government was frequently exposed to the danger of losing parliamentary support if it failed to meet the requirements of a very divergent majority, which had a direct impact on its stability and efficiency.

The outcome of the 2007 parliamentary elections has revealed a new trend in the Croatian political and parliamentary life – bipolarisation. The number of parties that made it to the parliament significantly went down, and two major parties (HDZ and SDP) won approximately 80% of votes. As it was mentioned before, for the first time in the country's history, the coalition agreement was thoroughly negotiated and the details of its future work were agreed upon and specified in a document of more than 100 pages. This was mainly due to two reasons. The complexity of the political framework that shall incorporate the main determinants of each partner's programs and the lessons learned from the problems of the 2000–2003 coalition, which was formed on the basis of a so-called policy-blind political agreement. Power sharing was conducted in the same manner as in the previous coalitions,

⁶⁹ HSU – Croatian Pensioners Party.

⁷⁰ HDSS – Croatian Democratic Peasant Party.

mainly respecting the profile of the parties⁷¹, while ‘the most important innovation’ that had a direct impact on the credibility of the government abroad is the fact that a representative of the Serbian minority was appointed Vice-president of the government for the first time in modern Croatian history.

The relatively short term in office – the elections were held in November 2007, and the government was formed in January 2008 – prevents us from conducting a deeper analysis of the political consequences of the applied power sharing model or of its general efficiency. It ‘managed to survive’ two major tests of stability – the temporary termination of the application of the Protected Ecological-Fisheries Zone towards the EU members (which was part of the HSS pre-election program’s headlines) and the recognition of Kosovo’s independence (taking into consideration that a representative of the Serbian minority is the Vice-president of the government). However, due to a very demanding EU accession schedule, which includes many challenges and unpopular moves that will have to be done at home.

1.5 The changes of the political pParty-preferences, the struggle for power, and political populism

1.5.1 The background of political preferences during the 1990s

The last two decades surely represent the most dynamic period of the Croatian political history, and therefore, it is interesting to see the background of the processes that took place during that period. The dissolution of the former federation, the independence and sovereignty of the new states, the change of the political and economic system, burdened with war and aggression, definitively represent processes of recognisable complexity and importance. The new possibility to choose among different political programs in the framework of free and multi-party elections raises several questions about voters’ political preferences and the different reasons for them.

What are the social, political, historical, personal or other reasons for the political preferences manifested by the voters? Is there a consolidated system of electoral preferences? The answers to these or similar questions provide us with very important information on the behaviour of the electorate, which has a direct impact on party preferences and the party system as such. In accordance with a need to ‘articulate’ the preferences of the electorate and

⁷¹ The exception is the post of the Minister of Tourism, which was given to HSS.

comprehend their impact on the development of the party system, Siber simplifies the problem by dividing the political spectrum only to left and right wing, differentiating groups of parties according to the following orientations:

- Ethnocentrism/aggressive nationalism vs. national tolerance;
- Traditional rural values vs. modern urban values;
- Euro-scepticism and xenophobia vs. a pro-European attitude.⁷²

First of all, Siber claims that the position of an individual in a society and his or her place in the societal division of labour directly affects the structure of his/her needs, and hence, his/her mindset and political preferences. However, he finds it difficult to apply these principles in the analysis of the Croatian political reality. The lack of democratic tradition and the traditional social structure, formed on the basis of private property and a market economy, the long period of a single-party system and the communist ideology, have made it almost impossible to identify a simple link between social status and political preference, which can be seen from the following table.

Table 1.8 Social position and party preference

PROFESSION	1990			1992			1995			2000		
	L	C	R	L	C	R	L	C	R	L	C	R
WORKER	36.1	10.8	53.1	6.3	37.8	55.9	4.5	40.4	55.1	28.0	42.3	29.7
PEASANT	30.0	23.0	47.0	4.0	36.0	60.0	4.2	46.2	49.6	37.6	50.0	12.4
ENTERPRENEUR	23.6	20.9	55.5	6.3	41.7	52.1	8.0	43.0	49.0	25.0	46.5	28.5
PUBLIC SERVANT	59.3	12.9	22.8	9.1	45.7	45.1	10.0	48.5	41.5	34.0	44.0	23.0
EXPERT	50.8	25.2	24.0	14.1	51.6	34.4	9.0	52.0	39.0	46.0	32.0	22.0
MILITARY, POLICE	92.4	2.5	5.1	4.4	35.6	60.0	4.3	14.0	81.7	18.1	27.3	54.6
HOUSEWIFE	29.5	22.3	48.2	5.4	28.7	65.9	8.0	25.0	67.0	23.4	41.6	35.0
STUDENT	35.6	22.4	42.0	10.7	54.6	34.7	4.5	51.5	44.0	59.7	32.7	7.6
PENSIONER	52.5	18.5	29.0	17.0	34.0	49.0	11.0	25.0	64.0	40.0	29.0	31.0
UNEMPLOYED	25.0	23.4	51.6	7.1	39.0	53.9	-	-	-	48.8	37.2	14.0

Remark: L, C, and R stand for left, centre, and right, respectively. The category 'unemployed' was not part of the 1995 opinion polls.

Source: Ivan Siber, "Politicko ponasanje biraca u izborima 1990-2000," in ed. Mirjana Kasapovic, *Hrvatska politika 1990-2000* (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2001): 73.

⁷² Ivan Siber, "Politicko ponasanje biraca u izborima 1990-2000," in ed. Mirjana Kasapovic, *Hrvatska politika 1990-2000* (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2001). This part of the section will be mainly based on this piece of research.

The data shows two trends: first, the differences among the given categories were significantly lower than in stable and traditional democracies; and second, the big changes of the political preferences from 1990 to 2000 reflect the general changes towards some parties or groups of parties in that period. In short, these are some of the general conclusions of the opinion polls:

- The preferences of some groups of the public tend to follow the general changes in the society;
- Students proved to be the most flexible group, which shows the main trends of the general changes;
- The party preferences of the police and army personnel were greatly dependent on the ruling regime (prior to 1990 and from 1990 to 2000);
- Public servants and experts represent the social basis of the parties on the left and in the centre of the political spectrum;
- Pensioners and housewives mainly represent the most inert group of voters, which mainly conforms with the dominating political trends;
- Workers and entrepreneurs supported right-wing parties in the 1990 elections, but they rejected them in the 2000 elections;
- Peasants, who are mainly undecided, mostly support HSS as a party from the centre, but by also supporting it in the 2000 elections in the left-centre coalition, they have supported left-wing parties as well.⁷³

There is another important element that is characteristic of the societies of new-born countries in the 1990s, and hence, of Croatia as well. Namely, owing to the fact that the process of political and economic transition was directly connected with the creation of the independent nation state, ideas like a nation and a state became very important and somehow managed to overshadow the impact of the social structure on the definition of voters' main values and political preferences. In other words, the process of the establishment of new social relations within the society had been formed after the dominating national state-building process. Unfortunately, the creation of the nation state in Croatia had been conducted in a disastrous war environment, which caused transnational homogenisation for the purpose of a common defence, as well as the marginalisation of the importance of social orientations. One may conclude that, owing to the difficulties of the transitional process,

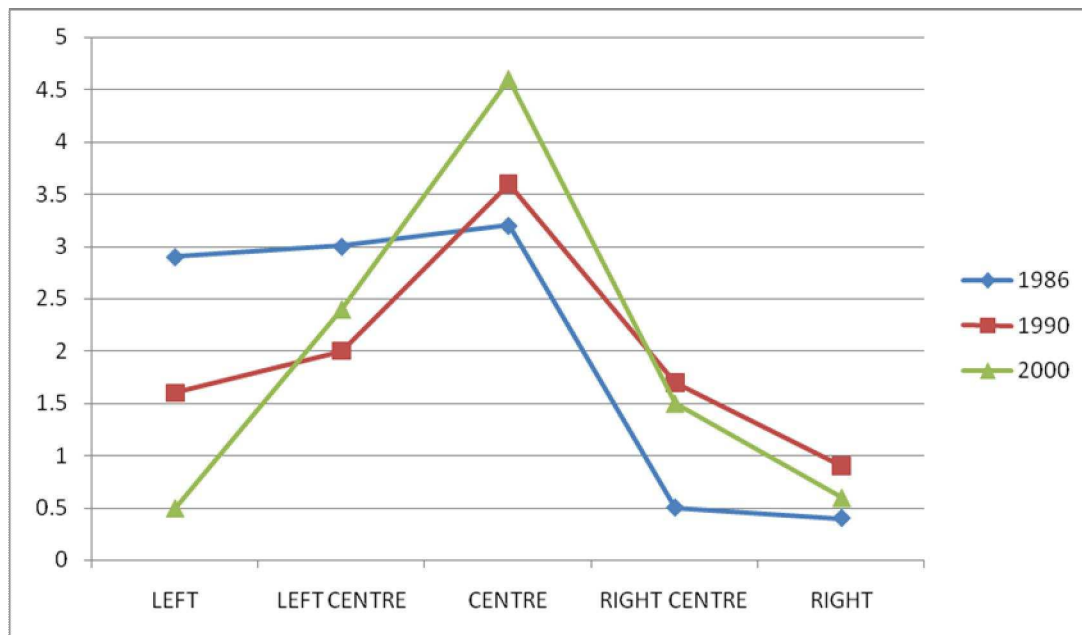
⁷³ Ibid, p. 75.

Croatia still did not have a stabilised social structure that may have served as a basis of an interest-oriented differentiation between societal groups.

The ideological ‘left-right self-identification’ represents one of the elementary showcases of individuals’ political preferences. Regardless of the complexity of the political and economic context, people tend to want to simplify them and affiliate with one of the few main categories, which helps a lot in the efforts for a general evaluation of the political preferences of the target group.

It is important to stress that the meaning of the terms ‘left’ and ‘right’ have significantly changed during the last two decades. While ‘left’ had previously meant an orientation towards the concept of state-monopoly in the economy and the clash of classes, today it means advocating better standards, social environment, gender equality, etc. On the other hand, the meaning of ‘right’ from the early 1990s (extreme nationalism, isolationist xenophobia, etc) has changed into the contemporary modest conservative approach towards issues in the society and international relations, mainly owing to the positive impact of the ‘Euro-Atlantic processes’.

Figure 1.1 Changes in the left-right self-identifications, 1986-2000



Source: Ivan Siber, “*Politicko ponasanje biraca u izborima 1990-2000*,” in ed. Mirjana Kasapovic, *Hrvatska politika 1990-2000* (Zagreb: Biblioteka Politicka misao, Hrvatska politologija, Fakultet politickih znanosti, 2001): 86.

As in the case of political preferences, the public opinion polls from the 1990s reveal that ideological self-identification mainly followed the general trends in the society at that time. While the leftist political orientation dominated in 1990, owing to the negative validation of the rightist orientation at that time, the same trend (with opposite data) is noticeable from the opinion polls during the war. The beginning of the political consolidation in 2000 is marked by the fall of both left and right self-identification and the rise of identification with the political centre.

1.5.2 Conformity with the EU 27 public opinion on the main trends in contemporary societies

The political changes that happened in 2000, followed by the introduction of the SAP from the EU side, have opened new perspectives for the accession. This marked the start of ‘a real transition process’ in Croatia, which significantly influenced the political preferences in the country, making general trends more comparable with the European ones.

1.5.2.1 Attitude towards the EU*

According to the Eurobarometer 68 survey, during the last six months, the positive attitude towards the EU has risen by four percent, while the scepticism towards the EU went down by three percent. However, there are still a significant number of citizens with a neutral attitude, although that is modestly declining as well.

Table 1.9 Attitude towards the EU in Croatia*

	EU 27	CROATIA
POSITIVE	49% (52%)	34% (30%)
NEGATIVE	14% (15%)	27% (30%)
NEUTRAL	34% (31%)	37% (38%)
DOES NOT KNOW	3% (2%)	2% (2%)

*Data in brackets are from the spring 2007 opinion polls.

Source: *Country Report - Croatia, EUROBAROMETER 68, Autumn 2007* – http://ec.europa.eu/public_opinion/archives/eb/eb68/eb68_hr_nat.pdf

In contrast with the slight improvement in the Croatian case, the EU 27 public opinion is showing a decline in the positive attitude towards the EU, although its average is still fifteen percent higher than that in Croatia, which is mainly due to the aforementioned consequences of the demanding reforms in the final stage of the accession.

1.5.2.2 Attitude towards membership in the EU*

During the last six months, the number of Croatian citizens with a positive attitude towards Croatia's potential membership in the EU went up by six percent, while the same data for the EU 27 rose by one percent. This trend in Croatia shows a slight rise in the awareness of the positive consequences of the eventual membership in the EU, while the proportion of neutral people is still worrisome, especially for the political elite, taking into consideration the fact that the integration into the EU can be done only on the basis of a positive outcome of the referendum.

Table 1.10 Attitude towards membership in the EU*

	EU 27	CROATIA
POSITIVE	58% (57%)	35% (29%)
NEGATIVE	13% (15%)	25% (28%)
NEUTRAL	25% (25%)	37% (40%)
DOES NOT KNOW	4% (3%)	3% (3%)

*Data in brackets are from the spring 2007 opinion polls.

Source: *Country Report - Croatia, EUROBAROMETER 68, Autumn 2007*, http://ec.europa.eu/public_opinion/archives/eb/eb68/eb68_hr_nat.pdf

1.5.2.3 The perception of the potential benefits from the EU membership

While the rise in the positive answers and the decline of the negative ones can be seen from the next table, it is interesting to compare data from the previous two tables. This reveals a difference between the symbolically and pragmatically formulated questions on the same matter and uncovers two trends in Croatia. While the symbolical popularity of the EU was rising, although it remains pretty low (35%), the awareness of the benefits of Croatia's potential membership in the EU is rather high (47%), which shows voters' pragmatism. While to a certain extent the 'grey image' of the EU in Croatia from the early 1990s, combined with the pressures of the conditionality in the final stage of the accession still have a rather negative impact on the EU's popularity at a symbolical level, the general awareness of the benefits of the potential membership is on the rise and represents a significant potential for the forthcoming demanding period of the European integration.

Table 1.11 Do you think that your country (will) benefit(s) from the membership in the EU?*

	EU 27	CROATIA
YES	58% (59%)	47% (43%)
NO	29% (30%)	44% (48%)
DOES NOT KNOW	13% (9%)	9% (9%)

*Data in brackets are from the spring 2007 opinion polls.

Source: *Country Report - Croatia, EUROBAROMETER 68, Autumn 2007*, http://ec.europa.eu/public_opinion/archives/eb/eb68/eb68_hr_nat.pdf

1.5.2.4 Attitude towards the future of the EU

The following table shows the rise of optimism in Croatia regarding the future of the EU, as well as a decline in pessimism. Despite the fact that it is still lower than the average EU 27, especially in comparison with surveys from a couple of years ago, it has been gradually growing in the last years in the country.

Table 1.12 Attitude towards the future of the EU*

	EU 27	CROATIA
OPTIMISTIC	66% (69%)	57% (53%)
PESIMISTIC	26% (24%)	37% (41%)
DOES NOT KNOW	8% (7%)	6% (6%)

*Data in brackets are from the spring 2007 opinion polls.

Source: *Country Report - Croatia, EUROBAROMETER 68, Autumn 2007*, http://ec.europa.eu/public_opinion/archives/eb/eb68/eb68_hr_nat.pdf

It is important to underline that none of these trends are accidental. They are the results of a long-term commitment from both Croatia and the EU for the European integration process of Croatia. This is of utmost importance for the democratic development and the marginalisation of the populist forces in Croatia. It is enough to compare their representation in the Croatian parliament in the 1990s, which was paramount (both within the extreme right parties and HDZ during the ‘Tudjman time’), and today (only one seat for the HSP) to see another irreversible positive effect of their elimination from parliamentary life.

1.6 Conclusions

The transformation of the political system in Croatia to a certain extent may be compared with similar processes in the societies of Central and Eastern Europe. However, this process in Croatia has some special characteristics, which distinguish it from the other countries: the

state building process had been conducted in parallel with the Homeland war, which significantly affected the dynamics of the political transformation during the 1990s. Apart from the burden of the war, there was another element that had negatively affected the transformation process in the 1990s, and that is the semi-autocratic nature of the political elites, which were, while declaratively opting for a 'European Croatia', showing a very modest political will for their claims. A combination of these two elements left the country far behind the average pace of the transition shown by the countries of the fifth enlargement. The political and economic systems burdened with the consequences of the war and the rudimentary democratic culture praxis simply could not offer answers to the transitional challenges that followed the fall of the communist system.

Therefore, the 'real transition' in Croatia started with 'a decade of delay' in comparison with the other Central and Eastern European countries. The turn of the century brought a semi-autocratic regime to an end, opening new perspectives for the Croatian democratic future. One of the most important consequences was that the necessary transitional reforms, the integration into the Euro-Atlantic community, processes that had been frozen for a long period of time, started taking place and began moving the country forward. In that sense, the inauguration of the Stabilisation and Association Process (SAP) from the EU side at the Zagreb Summit (2000), which for the first time offered a possibility for full-fledged EU membership for countries from the region, represented the main turning point in the relations between the EU and Croatia and a main motor of the transitional reforms. Its conditionality and mechanism has had an extraordinary importance for the pace and direction of the Croatian transitional efforts, while the principle of 'own merits' guaranteed the individual evaluation of each country from the region and removed the political concerns from the regional SAP package that were dominating the political discourse in the country.

The complex of changes had a significant impact on the whole political system and political preferences in general. Apart from that, the changed political environment brought the practice of consensual power sharing to Croatia for the first time, due to the fact that the political performances of the parties made the individual formation of a government impossible, so the 'era of coalition' started in 2000, which has continued until the present. The importance of the fact that no single party can form a government in the period of crucial transition changes speaks for itself. While on the other hand, it is a symbolic proof of the positive impact of the process of the European integration on the political praxis in Croatia, and the parliamentary one in particular. The reflection of the broad political consensus on the

importance of the EU accession process is formalised in the parliament by the formation of the so-called *Pact for Europe*, which gathers all parliamentary parties in a joint effort to improve parliamentary work as an important element of the accession process.

Therefore, it is obvious that the process of European integration remains to be of utmost importance for the ongoing process of political transformation in Croatia. As it was presented in this study, it helped changing the political discourse in the country, by introducing new elements that make the trends of the Croatian society comparable with the ones of the European Union and eliminate the former populist rhetoric and values, which have had a negative impact on the transitional process and political preferences in Croatia. The continuation of this process and the finalisation of the accession to the EU are vital guarantees for the continuation of these positive trends in the Croatian political transformation, and they represent a major priority for both the political elites and the society in general. Only this will ensure a sustainable democratic development in the country and offer it a possibility to support similar processes in the region, where Croatia with its experience can play a significant role as a partner of the EU in its long-term efforts for regional stabilisation.

In general, one may expect Croatia to continue speeding up its reforms in order to finalise the accession process with the EU within a reasonable period. Despite the fact that nobody really wants to forecast the accession dates, especially owing to the fact that the quality of the negotiation and the preparation for membership is far more important than the timetable of the accession itself, there are some estimations that, if the country manages to finalise the negotiation process during the next year, it may be expected that it will probably be able to join the EU in 2011, the earliest. However, one should not forget the fact that Croatia will have to show the capability of conducting very demanding reforms in a rather short period of time in order to achieve these goals. On the other hand, despite the assurances given by the highest EU officials about the Croatian European perspective, the outcome of the Irish referendum on the Lisbon Treaty has raised a number of questions regarding the future institutional arrangement of the EU, and we still have to see how this will affect the continuation of the enlargement.

Regardless of the potential obstacles to the Croatian membership in the EU that we just have mentioned, it is very difficult to imagine that the country's accession would be blocked and that the EU enlargement process would be stopped in the period to come. Therefore, it may not be too early to start thinking about the political reality in Croatia once it joins the EU. Thanks to the experience of the Central European countries, one may already be

aware of the fact that once the transitional country fulfils its two main foreign policy goals – full fledged membership in the EU and NATO – the dynamics of the internal political life will significantly change, affecting the relations between the main political parties. Namely, as it was mentioned before, all the major parties in the parliament decided to join forces in the *Pact for Europe*, in order to facilitate parliamentary procedures as well as other aspects of the Croatian EU bid. Once the common goal is achieved, the grounds for consensus will probably be narrowing down, so one may expect parties ‘to take a harder stand towards each other’, and thus, bring a new dynamics into the political life.

The future membership in the EU and NATO will definitively influence Croatia’s foreign policy by offering it a possibility to use its comparative advantage to contributing to the efforts of these two organisations in their endeavour to ensure the stability of South East Europe. Aware of the fact that it has too limited capabilities to contribute significantly to the efforts of the international community in some other distant parts of the globe, the country may be expected to concentrate on the region, where it can prove to be a recognisable stabilising partner of the transatlantic community. Apart from that, as it is visible from the recent trends of increase, Croatia’s participation in peace-keeping missions around the globe will continue ensuring its contribution to the international mechanisms of collective security in accordance with its limited capabilities. Apart from that, its current position of non-permanent member in the UN Security Council and the active role it is playing there, additionally confirms its willingness to contribute to international stability in general and proves the fact that Croatia has successfully managed to transform from *a security consumer* into *a security provider*.

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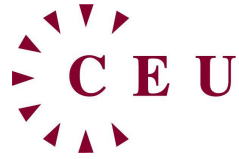
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CHAPTER 2 - ECONOMIC DEVELOPMENTS

Study prepared by

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Paper prepared in the framework of the project:
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2.1 The economic history of the transition between 1990-2006

2.1.1 Macroeconomic aspects: The development of the main indicators

Croatia's economy suffered badly during the 1991-95 war, as the output collapsed. The direct war damage has been estimated at USD 27 billion⁷⁴, and the country missed the early waves of investment in Central and Eastern Europe.

Table 2.1 Summary table of main economic indicators in Croatia

	GDP at PPPs (EUR million)	GDP growth, (% yoy)	Inflation (CPI)	Export of goods (EUR million)	Import of goods (EUR million)	Trade balance, % GDP	Current account balance (% GDP)	FDI inflow EUR million
1990	32 775	-7.1	609.5			-		
1991	37 208	-21.1	123.0			-		
1992	24 743	-11.7	665.0			-		
1993	22 869	-8.0	1 517.5	3 384.2	3 998.0	-6.5	5.5	100.9
1994	24 696	5.9	97.6	3 724.4	4 805.9	-8.8	4.8	94.9
1995	26 780	6.8	2.0	3 496.0	5 993.9	-17.2	-7.6	84.0
1996	29 273	5.9	3.5	3 735.1	6 520.4	-17.6	-5.0	394.0
1997	32 102	6.8	3.6	3 557.2	8 319.6	-26.8	-12.6	476.6
1998	33 515	2.5	5.7	4 083.6	7 713.3	-18.8	-6.8	842.8
1999	33 882	-0.9	4.2	4 134.1	7 240.0	-16.6	-7.0	1 369.2
2000	35 992	2.9	6.2	4 969.3	8 468.7	-17.5	-2.4	1 138.5
2001	38 307	3.8	4.9	5 318.8	9 922.6	-20.8	-3.6	1 502.5
2002	41 407	4.4	1.7	5 293.1	11 253.4	-24.4	-8.5	1 196.9
2003	43 658	5.6	1.8	5 571.7	12 545.9	-26.6	-7.1	1 784.5
2004	46 906	5.3	2.1	6 603.1	13 330.9	-23.5	-5.1	990.3
2005	49 536	4.3	3.3	7 216.6	14 738.3	-24.1	-6.4	1 424.9
2006	52 082	4.8	3.2	8 433.6	16 797.5	-24.4	-7.8	2 837.6

Source: WIIW

Negative trends in GDP growth, employment, investment, consumption, exports, imports, the level of the utilization of economic potentials and a high monthly rate of inflation started in 1990 and continued until 1994. The economic stabilisation effort that started in late 1993 delivered price stability (in the period 1994-97, inflation was 3.7%,) and an average annual GDP growth of over 6% during 1994-97, but the external current account deficit reached 13% of the GDP. Still, despite the economic growth, in the same period the net change in employment was persistently negative, mostly as a consequence of the slow restructuring and modernisation of the economy.

⁷⁴ Commission services report, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions set out in the Council Conclusions of 29 April 1997; Bosnia-Herzegovina, Croatia, Federal Republic of Yugoslavia, (Brussels, 1997), http://ec.europa.eu/enlargement/pdf/key_documents/9710_report_a_en.pdf.

The economic situation started to deteriorate in the course of 1997, when the country experienced a loss of international competitiveness, resulting in a reduction of exports (-5%) the continued growth of imports (28%), a widening current account deficit (from 5% to 12.6% of the GDP) and a sharp increase of the external debt. The adoption of the amendments to the Company Law abolishing the condition of reciprocity coincided with a more significant FDI inflow, which started in 1999. The already high unemployment continued to increase in the period 1998-2000 and reached an average rate of 16.1% in 2000 (labour force survey based on ILO standards; 1999:13.6%). The official rates were even higher. The unemployment was the result of wage increases above the productivity gains, which was aggravated by the period of slow economic growth. Especially alarming was the rate of youth unemployment (up to 25 years of age) of about 30%.

Tightening the monetary policy, flagging the domestic demand and political interference in the economy resulted in a rapid build-up in the domestic arrears of public and private enterprises and resulted in serious solvency problems in the banking sector. The combination of the mounting structural problems, increases in taxes and administered prices, as well as the impact of the Kosovo crisis contributed to the recession that started in the last quarter of 1998 and continued through the first three quarters of 1999. The imports were decreasing (7% in 1998 and 6% in 1999, yoy) and the exports were increasing. The GDP started to grow again in the last quarter of 1999, albeit at modest levels. For the whole year of 1999, the GDP contracted by 0.9%⁷⁵, but in 2000, real GDP grew at some 2.95%, coming from a strong rebound in household consumption. However, unemployment continued to grow until 2000, when this trend reversed.⁷⁶

Since 2000, GDP growth has been moderate but steady, led by a rebound in tourism and credit-driven consumer spending. Inflation over the same period has remained the same and the currency, the Kuna, has remained stable.

In the period 2000-03, the government's failure to press the economic reforms needed to spur growth was largely the result of coalition politics and public resistance, particularly from the trade unions.⁷⁷ The current account deficit was widening. However, in this period

⁷⁵ In this chapter we use WIIW data. The documents of the European Commission present different numbers. E.g. according to the Western Balkans in Transition, 2001, available from http://ec.europa.eu/economy_finance/publications/european_economy/2001/c2001_03_en.pdf p. 10, the GDP in 1999 contracted by 0.4%, and the current account deficit in 1997 reached 11% of the GDP.

⁷⁶ The Western Balkans in Transition, *European Economy occasional papers*, no. 1 (January, 2003), 11. http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocp1en.pdf.

⁷⁷ CIA – The world factbook 2002, “Economy overview : Croatia,” <http://www.facts.org/docs/factbook/fields/2116.html>.

(2001-03), the exports grew faster than the imports, and there were some more significant FDI inflows. A key objective of the government in the period 2004-07 was achieving macroeconomic growth and stability by eliminating external imbalances and creating a transparent fiscal system. Nevertheless, macroeconomic challenges have remained, including high unemployment, a growing trade and current account deficit, and uneven regional development. The state has retained a significant role in the economy, and privatization has not been completed, but the EU accession process should accelerate the fiscal and structural reform.

2.1.2 Transformation and privatisation

The basis for the transformation of the social ownership of enterprises was provided by the Transformation Act that was adopted in 1991. According to the Transformation Act and Company Law, socially owned companies had to have a market-oriented management board and a shareholders' assembly. The equity of a company belonged to the personal shareholders, to the social security institutions and to the state. Thus, enterprises began working as market entities. The state's shares have been conducted by the Croatian Privatization Fund, which has been responsible for monitoring the privatization process. In other words, the Transformation Act did not implement the privatization of enterprises in full, but rather created the legal conditions for its implementation in the next stage of privatisation, when the Croatian Privatisation Fund was expected to sell out its shares on the stock market.⁷⁸

The transformation of social ownership was largely completed (under the Transformation Act) by 1995, one exception being the territories of the Republic of Croatia that had been occupied during the war. Therefore, it was necessary to legally regulate the procedures for the privatization of those assets transferred to the Croatian Privatization Fund in the social ownership transformation process, i.e. the assets which, pursuant to special regulations and in a legally permissible fashion, became the property of the state, counties, cities, or municipalities.⁷⁹

⁷⁸ Stjepan Zdunić, "Central Europe and Croatian foreign Trade Policy," in *Croatian Economic Survey*, no. 2 (1994), http://hrcak.srce.hr/index.php?show=toc&id_broj=651.

⁷⁹ Official Gazette of the Republic of Croatia, no. 21(1996), 71 (1997) and 73 (2000).

The Privatization Act, which regulates the criteria and procedures for the privatization of those assets not privatized during the transformation process, was adopted in 1996⁸⁰. The process of privatisation started thus following the transformation although it has not been completed yet. It was expected that the privatisation of the state portfolio would be finalised by the end of 2005. However, the pace of privatisation was slower than planned and further complicated by corruption scandals.

A Law on Compensation for Expropriated Assets was also adopted. The law foresaw the restitution of assets either in kind, through shares reserved in the Croatian Privatization Fund, or by payment from the Croatian Compensation Fund.

2.1.3 Liberalisation and economic integration

In spite of the war and the risky environment in the early 1990s, the main characteristic of the foreign trade policy was liberalisation. Croatia became a member of the IMF in December 1992 and did not maintain any restrictions on payment and transfers for current international transactions.

Since 1993, free entry into foreign trade was guaranteed, domestic and foreign companies have the same legal treatment, and foreign and domestic investors have the same legal status. The gradual abolishment of price controls followed. Since the second half of the 1990s, the prices of goods and services in most sectors have been determined freely by market forces. In the late 1990s, the direct price controls in force were obligatory prior to reporting price changes for a limited number of products.⁸¹ The requirement of a prior reporting of price changes for certain goods and services was not applied to imports or exports. The government could also prescribe price controls, but only in exceptional circumstances, for a limited period of time. Price controls were gradually abolished in most sectors. In 2002, the Commission's Report on Croatia's level of price liberalisation was considered advanced, as the use of administered prices in Croatia was limited to agricultural products, energy and transport.

⁸⁰ "Privatisation Act," *Official Gazette*, no. 21 (March 14, 1996.)
<http://www.nn.hr/clanci/sluzbeno/1996/0392.htm>.

⁸¹ These were: milk for daily consumption; fertilizers; wheat flour; bread type 850; petroleum products; natural gas; electric energy; radio and television subscriptions; the transportation of passengers and freight by local rail or maritime line traffic; standard letters and postcards; telephone impulse and telephone subscription; road, bridge and tunnel tolls; official forms; round-wood logs; cubic wood; and the services of loading and transportation of wood sorting.

However, despite the liberal trade policy, Croatia was slow in economic integration. In 1991, Croatia was not willing to join CEFTA, and later it had difficulties in meeting the criteria (WTO membership, agreement with the EC, and bilateral trade agreements). Croatia joined the WTO in 2000, and by then it had concluded free trade agreements only with Slovenia and Macedonia (in 1997). By 2002, Croatia's trade was under the free trade regime with four countries: Macedonia, Slovenia, Hungary and Bosnia Herzegovina. The process of trade liberalisation was then speeded up, and by 2004, 80% of Croatia's trade was under the free trade regime. In addition to a number of bilateral free trade agreements, Croatia also concluded free trade agreements with regional integrations: in 2001 with EFTA and the EU, and in 2003 it joined CEFTA. The CEFTA 2006 agreement, providing for the creation of a free trade zone in South East Europe by 2010, came into effect for Croatia in 2007.

2.1.4 Developments of the monetary and fiscal policy

Following the secession from Yugoslavia, Croatia ceased to be a part of the monetary system of the former SFRY in June 1991. All business relations between the Croatian commercial banks and the former Central Bank were broken off. Croatia issued its own currency. The Croatian Dinar replaced the Yugoslav Dinar in December 1991. It was a transitional currency until June 1994, when it was replaced by the Croatian Kuna. The Dinar was replaced by the Kuna at a rate of 1 Kuna = 1000 Dinars. The introduction of the Kuna enabled the implementation of the government's stabilisation programme, which was launched in 1993. One of its main instruments was a restrictive monetary policy, the reduction of the budget deficit, and the elimination of the current account deficit.⁸² The monetary policy has been very successful in reducing the inflation by using the exchange rate as the nominal anchor. The policy can be described as strict exchange rate targeting. It is characterized by a very low tolerance to exchange rate movements and the significant role of the Central Bank in the foreign currency market. The Kuna was implicitly pegged to the Deutsche Mark.

The strict exchange rate targeting has been successful in achieving a high level of price stability in the mid-1990s. The price stability was defined as the primary objective of

⁸² Government, "Osnove stabilizacijske politike," (1992)
<http://northwesternerbybirth.googlepages.com/RezimeOsnovestabilizacijskogprograma.doc>.

the monetary policy by the 1992 Law on the Croatian National Bank.⁸³ By defining price stability as the primary objective, the emphasis on the exchange rate was reduced.⁸⁴

In 2000, the Central Bank relaxed the restrictive monetary policy: it lowered the interest rates and softened the mandatory reserve requirements. New instruments were introduced: repo operations and the auctions of foreign currency denominated Croatian National Bank bills. The legislative changes introduced enabling the development of the financial market provided opportunities for a more active use of the market mechanisms. Since 2005, there are regular open market operations.

As regards fiscal policy, the period of 1993-98 was marked by significant changes of the tax system with the objective of its modernisation and the establishment of a system compatible with the market economy. In 1994, profit tax, income tax and excises were introduced. The reform of custom duties followed in 1996, and in 1998, value added tax was introduced, replacing turnover tax.

During 1999, the state was not servicing its obligations regularly, which contributed to serious liquidity problems. The issue was tackled by the fiscal policy, i.e. by timely payments. During 2000, the tax burden was diminished, which was reflected in the decreased share of the budget revenue in GDP. The expenditures decreased accordingly. The basic personal deduction increased, and a 15% tax rate was introduced. The profit tax rate decreased from 35% to 25%, and incentives for investments were introduced. The fiscal deficit continued widening, which required the tight control of the public spending and the managing of the public debt. In 2001, the treasury was created, and in 2004, transparency was further enhanced by the inclusion of all expenditures of the Croatian Railways and the Croatian Motorways in the budget.⁸⁵

2.1.5 Main economic challenges

The starting point of the economic policy documents, the Strategic Development Framework (SDF), is that government-driven growth is not sustainable in the long run. Required is the strengthening of the private sector, its competitiveness and its overall ability to become the

⁸³ "Regulation on National Bank of Croatia," *Official Gazette*, no. 71 (1991), <http://www.nn.hr/clanci/sluzbeno/1991/1846.htm> and "Law on National Bank of Croatia," *Official Gazette*, no. 74 (1992), <http://www.nn.hr/clanci/sluzbeno/1992/1966.htm>

⁸⁴ Andreas Billmeie and Leo Bonato, Exchange Rate Pass-Through and Monetary Policy in Croatia. *IMF working paper 02/109* (IMF, 2002).

⁸⁵ Manuel Benazić, "Fiskalna politika i gospodarska aktivnost u Republici Hrvatskoj: model kointegracije," *Ekonomski pregled*, 57 (2006).

main driver of future economic growth. The key areas that can challenge growth and competitiveness relate to the completion of the transition process (mainly related to the reform of the judiciary and public service), development of human resources (education, efficient labour market) and developmental links (macroeconomic environment, efficient and integrated financial services, natural resources and regional development).

The elimination of the administrative barriers for business development, a labour market reform, the reform of the education system, the reform of social welfare and related social benefits are identified by the Pre-Accession Economic Programme 2008-10 as challenges that have to be tackled soon. The key fiscal policy objectives in the period between 2007 and 2009 include the reduction of the budget deficit below 3% of the GDP, stabilisation, and the further reduction of the public debt to less than 60% of the GDP, the decrease of foreign debt to values around 80% of the GDP and support to the decisive implementation of the structural reforms.

Other challenges that have to be tackled include undeveloped capital markets, the high unemployment rate combined with a high share of long-term unemployment (particularly among women) and a high level of youth unemployment; and the social exclusion of the long-term unemployed. The mismatch between the labour market requirements and the education system should also be tackled by a further reform of the education system.⁸⁶

The EU sees the problems somewhat differently, and as the main challenges that have to be tackled in order to meet the economic membership criteria, it identifies state aid, the restructuring of the loss making enterprises and the improvement of the efficiency of public spending.

2.1.6 Development in a broader sense

The main development indicators (HDI, literacy ratio, life expectancy) are presented in Table 2.2. According to the Human Development Report 2006/2007, the HDI for Croatia is 0.850, which gives the country a rank of 47th out of the 177 countries with data.

The education attainment levels of the population are generally below the EU standards. According to the 2001 census, 18.6% of the population aged over 15 have not completed primary school education, and 21.8% have completed only primary school. Only

⁸⁶ Central Office for Development Strategy and Coordination of EU funds, *Strategic Coherence Framework 2007-2013: Instrument for pre-accession assistance* (Zagreb: Central Office for Development Strategy and Coordination of EU funds, 2006), 36.

11.9% of the population have received education beyond the secondary-school level. Conversely, the percentage of the population aged 20 to 24 having completed at least secondary education was almost 98.3% in 2005. Such a high attainment is not achieved in tertiary education, in spite of the high enrolment rate (over 70% of those who completed secondary education) due to the long duration of studies and a high drop out rate. The gross enrolment ratio at tertiary level in Croatia increased significantly in the period 2002-03 compared to the 1998-98 level: the enrolment of women increased from 34.2 to 42.8% and that of men from 29.6 to 36.1%. This is significantly lower than in most new member states (e.g. Bulgaria, Slovenia, Poland, Estonia, Lithuania, one exception being Slovakia) and even Serbia and Montenegro, Ukraine and the Russian Federation.⁸⁷

Table 2.2 Main development indicators

	Human development index (HDI) value	Life expectancy at birth (years)	Adult literacy rate (% aged 15 and above)	Combined gross enrolment ratio for primary, secondary and tertiary education (%)	Life expectancy index	Education index	GDP index	GDP per capita (PPP USD) rank minus
2005	0.85	75.3	98.1	73.5	0.839	0.899	0.843	4
2004	0.846	75.2	98.1	73.0	0.84	0.90	0.80	7
2003	0.841	75.0	98.1	75.0	0.83	0.90	0.79	5
2002	0.841	75.0	98.1	75.0	0.83	0.90	0.79	5
2001	0.83	74.1	98.1	73.0	0.82	0.90	0.77	4
2000	0.811	74.0	98.4	68.0	0.82	0.88	0.75	7
1999	0.803	73.6	98.2	68.0	0.81	0.88	0.82	10
1998	0.795	72.8	98.0	69.0	0.80	0.88	0.70	7
1997	0.773	72.6	97.7	67.0	0.79	0.88	0.65	18

Source. OECD, *Human Development Report*, World Bank⁸⁸

Life expectancy in Croatia increased from 73 to 75 years in the period 1997-2005. Health indices, such as the infant mortality rate (which halved in the period 1991-2006),⁸⁹ or life expectancy, are also improving.

⁸⁷ UNESCO statistics. <http://status.uis.unesco.org/ReportFolders/reportfolders.aspx>.

⁸⁸ World Bank, "Human Development Report," http://ddp-ext.worldbank.org/ext/ddpreports/ViewSharedReport?REPORT_ID=7136&REQUEST_TYPE=EXCEL&HF=N&WSP=N

⁸⁹ The infant mortality rate per 1000 livebirths was 575 in 1991 and 215 in 2005. The data for each year show a continual decline of the infant mortality rate. *Croatian Health Service Yearbook 2006*, (Zagreb: Croatian national institute of public health, 2007), http://www.hzjz.hr/publikacije/hzs_ljetopis/.

As regards the raw physical infrastructure, progress has been most significant in the transport sector, which is still unevenly developed. The transport infrastructure consists of the following: 28,750 km road; 2,726 km rail track; six seaports of special economic importance, two of which are predominantly for freight transport and three predominantly for passengers; seven airports and two airfields; and 781.1 km waterways, with four river ports.

In five years (2001-05), the length of motorways in Croatia was more than doubled, which is the result of the implementation of the government's decision to connect all the vital areas and towns in Croatia by motorways.

The railway infrastructure still needs serious modernisation and restructuring. There are 62 kilometres of rail track per 100,000 inhabitants, while the EU-25 average is 45 kilometres. The length of railway lines in Croatia also exceeds the European average, but only 9% are double-track lines, and 36% of the lines have electricity. Activity in the transport sector is below the pre-war level, and the number of passengers in 2004 made up only 57% of the number of passengers transported in 1990.⁹⁰

In the period between 1990 and 2000, only 282 kilometres of railway lines were built (a 35.3 km average on an annual basis), which amounts for 8.8 per cent of all lines in Croatia, while around 75 per cent of the lines date from the Austro-Hungarian period.⁹¹

The modernisation of some of the airports and sea ports is also needed, and the transport and trade integration at the Port of Ploče and the construction of an international passenger terminal at the Port of Dubrovnik are identified as necessary for the development of the Core Network in South East Europe.

The information and telecommunication infrastructure is well developed, while the energy sector experienced serious war damage and needs investments.

2.2 Macroeconomic aspects

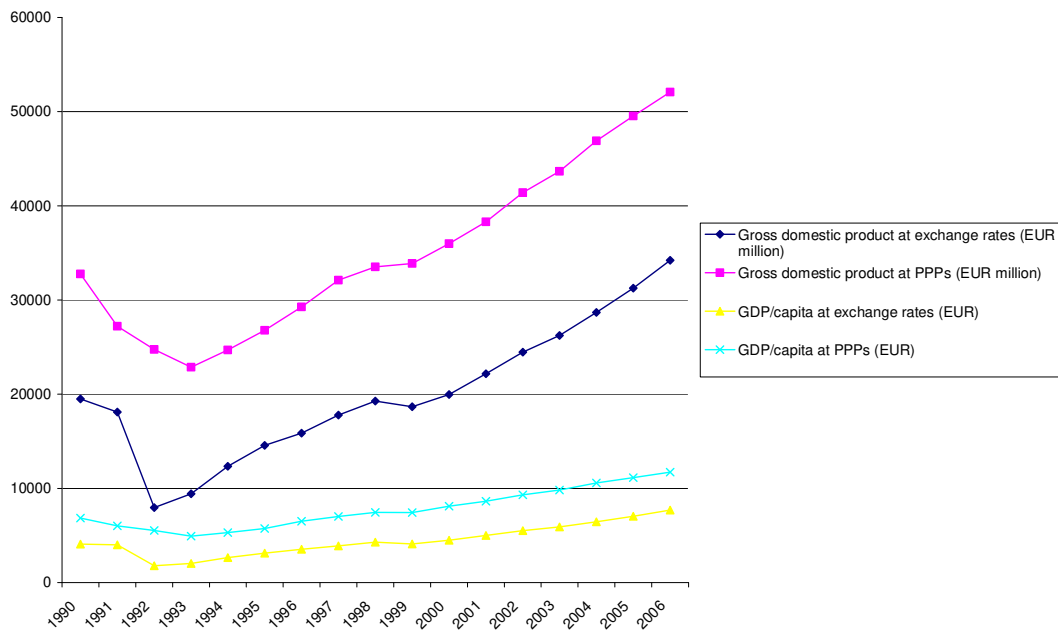
2.2.1 Economic growth

At the beginning of the transition, Croatia was a prosperous industrialised area, compared with the new EU member states and the South East European countries. However, Croatia's economy suffered badly during the 1991-95 war. The output collapsed, and the country missed the early waves of investment in Central and Eastern Europe.

⁹⁰ Strategic Coherent Development.

⁹¹ Croatian Economic Development.

Figure 2.1 The development of the GDP, 1990-2006



Source: DZS

Table 2.3 GDP per capita, 1990-2006

Year	GDP per capita, at exchange rate (EUR)	GDP per capita, PPP (EUR)	GDP per capita at exchange rate/GDP in PPP
1990	4 080	6 860	1.68
1991	4 013	6 030	1.50
1992	1 780	5 540	3.11
1993	2 033	4 930	2.42
1994	2 654	5 310	2.00
1995	3 118	5 740	1.84
1996	3 531	6 510	1.84
1997	3 891	7 020	1.80
1998	4 284	7 450	1.74
1999	4 102	7 440	1.81
2000	4 502	8 110	1.80
2001	4 995	8 630	1.73
2002	5 507	9 320	1.69
2003	5 906	9 830	1.66
2004	6 462	10 570	1.64
2005	7 038	11 150	1.58
2006	7 704	11 730	1.52

Source: WIW

The significant drop of the GDP per capita in the period 1992-93 was less dramatic in PPP terms, when the gap between the GDP *per capita* at exchange rate and in PPP was the highest (GDP per capita in PPP was three times higher than at exchange rate). The ratio between the GDP per capita at exchange rate and in PPPs has been steadily decreasing, from 3.1 in 1992 to 1.5 in 2006.

Croatia established a strong track record of policy implementation in the period 1994-97, when GDP growth was estimated at 5.5%. After a short recession, positive economic growth resumed at the end of 1999, driven by a rebound in household consumption, a booming tourist industry and a favourable external environment.

Despite the worldwide slowdown, the macroeconomic performance of Croatia was positive in 2001. The Croatian economy grew in 2001 by 3.8%, driven by domestic demand, notably private consumption, and a favourable tourism activity. Industrial production posted a solid growth of 6%, but the construction and agriculture sectors remained subdued. In 2002, the GDP grew by 4.4% (year-on-year), resulting from the continued growth of domestic demand, especially investment and personal consumption. The construction and the (wholesale and retail) trade sector displayed high growth rates. The tourism season was satisfactory but with lower growth rates than in the two years before.⁹² In line with the investment and consumption growth, value added in construction (+13.9%) and retail and wholesale trade (+12.7%) recorded the strongest gains.

In 2003, the Croatian GDP grew by 5.6% in real terms, which was the highest growth rate since the recession in 1999. The gross fixed capital formation remained strong; the private consumption growth somewhat cooled down, reflecting the high indebtedness of the households as well as slower credit expansion. Debt-financed public investment, especially in highway construction, measured up to the activity level of the previous year. The tourist season was good, as the overall earnings increase was estimated at 15% in 2003.⁹³

The GDP growth slowed down in 2004 to 5.3% (from 5.6%, yoy), and to 4.3% in 2005.⁹⁴ Industrial production grew by 5.1% in 2005 and by around 4.5% in 2006. ⁹⁵In 2006, real GDP growth accelerated to 4.8%. The economic output remained largely driven by

⁹² "The Western Balkans in Transition," *European Economy occasional papers*, no. 1 (2003), http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocp1en.pdf.

⁹³ "The Western Balkans in Transition," *European Economy occasional papers*, no. 5 (2004), http://ec.europa.eu/economy_finance/publications/occasional_papers/2004/ocp5en.pdf

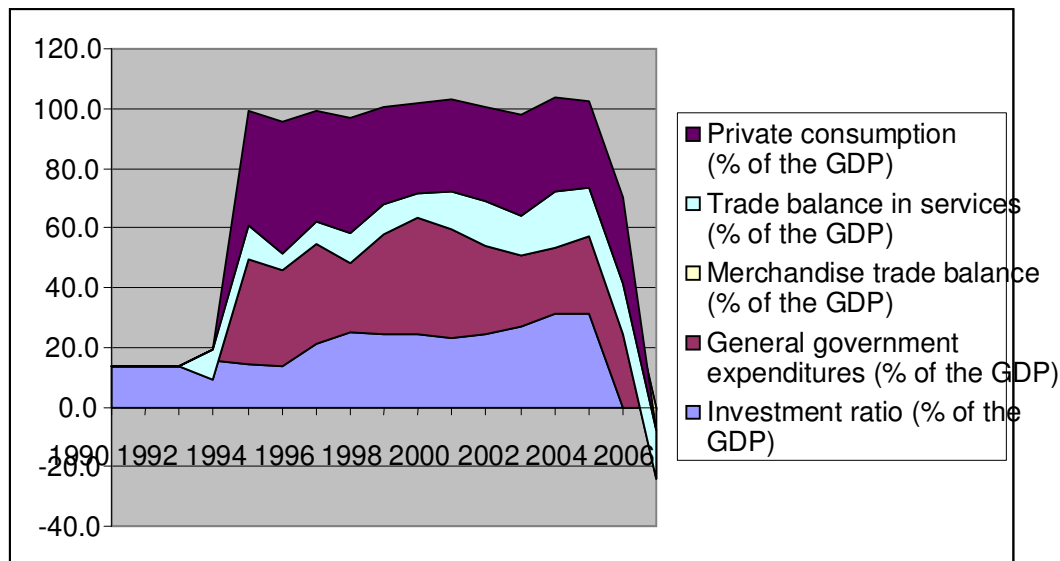
⁹⁴ WIIW data.

⁹⁵ "Western Balkans in Transition," *European Economy enlargement papers*, no. 30 (2006), http://ec.europa.eu/economy_finance/publications/publication1481_en.pdf

domestic demand. In particular, investment spending increased by 12.6%, strongly supported by a private sector initiative. The stronger private investment contributed to an acceleration of the total real investment growth to 10.9%, up from 4.8% in 2005. Private consumption grew by around 3.5% in real terms. The real growth of the imports of goods and services was slightly stronger (9.5%) than that of exports, and net exports posted a negative contribution to growth (2.2 percentage points). The economic growth remained robust in 2007. Real GDP growth accelerated further to 6.8% in the first half, and industrial production went up by 7% year on year in the first eight months of 2007. Overall, the economic performance remained strong, with real growth rates above the potential growth.

The investment ratio has experienced significant growth since 1990, from 13.7% of the GDP to a level of roughly 30%. The trade balance in goods deteriorated and the deficit increased from 6.5% in 1993 to 24.4% in 2006. In the same period, the balance in services significantly increased (from 10 to 17%), mostly caused by a boosting tourism. Government expenditures fluctuated around 50% of the GDP.

Figure 2.2 GDP and its components



Source: WIIW

Changes in the contribution of the main sectors to the GDP have been limited, indicating slow structural reforms. Despite the importance of tourism, the share of services reached 63% (up from 58 in 1990), which is still below the EU average (67% for the EU-15 in 2001). The share of agriculture, although decreasing (from 9% to 7%), is still significantly above the EU

average (2.3%) and that of the new EU member states (5%). The share of the industry decreased from 26 to 23%, (which is comparable with the EU levels), while the share of construction remained at the level of 6% (which is higher than that in the EU).

Figure 2.3 The contribution of the main sectors to the GDP, %

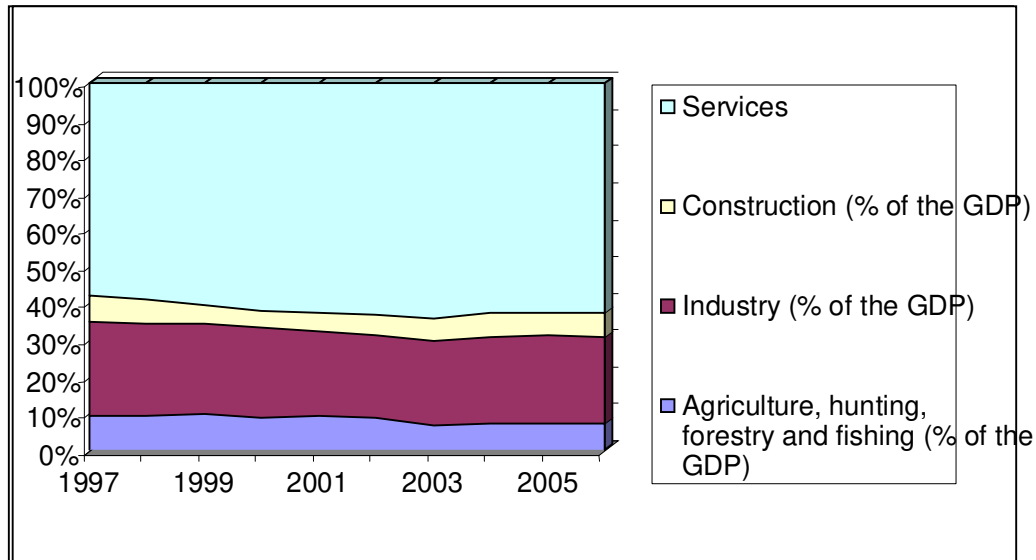


Table 2.4 Composition of GDP

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Agriculture, hunting, forestry and fishing (% of the GDP)	9.3	9.4	9.6	8.8	9.0	8.7	7.0	7.5	7.3	7.1
Industry (% of the GDP)	25.9	25.0	24.6	24.3	23.0	22.8	22.8	23.4	23.8	23.5
Construction (% of the GDP)	7.1	6.6	5.3	4.6	4.9	5.3	6.3	6.6	6.5	6.8
Services	57.8	59.0	60.4	61.9	61.8	63.1	63.9	62.5	62.4	62.6

Source: Eurostat, 2007

2.2.2 Prices and monetary conditions

2.2.2.1 Inflation and interest rates

A low inflation environment has been maintained since 1994. The average annual inflation rate, measured by the consumer price index, was around 3.4% since the mid-1990s.

Following the introduction of the VAT on 1 January 1998, when there was a one-shot increase of prices by 2.4% in January, price trends stabilised in the following months. The one-shot price increase was primarily the result of the increased burden in food taxation, of

about 2%. On the contrary, the manufacturers' prices in January and February 1998 decreased by 0.4% and 0.1%, respectively.

Croatia has maintained price stability using the exchange rate as a nominal anchor. The average retail price inflation fell from 4.9% in 2001 to 2.2% in 2002, ensuing from falling agricultural prices and the subdued growth of non-agricultural prices and despite the prominent inflation in services. Producer prices fell by 0.4% in 2002, but they showed an accelerating trend towards the end of the year. Retail price inflation in November 2003 (yoy) was 1.9%. Producer prices rose by a modest 0.9% (yoy).⁹⁶

The average annual consumer price inflation increased significantly, from 2.1% in 2004 to 3.3% in 2005, resulting from higher prices for energy (oil), transport and food. On a twelve-month moving average, the inflation further increased to 3.4% in October 2006, also fuelled by the adjustments of the administrative prices. The average producer price inflation stood at 2.9% in November 2006, slightly lower than a year before.⁹⁷

In December 2006, the CPI was 2% higher than in December 2005, while the average inflation rate in 2006 amounted to 3.2 percent. The increase of the inflation rate was mainly driven by the growth in the prices of services, i.e. the increase in the prices of water supply and utility services. In December 2006, the prices of services were 4.2 percent higher than in December 2005, while the prices of goods rose only by 1.4 percent. The producer prices measured by PPI rose by 1.9 percent in December 2006. Inflation was kept stable and relatively low due to the appreciation of the HRK/EUR exchange rate, the slow nominal wage increase, the mild labour productivity growth, and the intense competition in the retail trade.

It should be also noted that the trends in the development of the producer price index diverged from those of the consumer price index.

⁹⁶ "The Western Balkans in Transition." *European Economy occasional papers*, no. 5, (January, 2004), http://ec.europa.eu/economy_finance/publications/occasional_papers/2004/ocp5en.pdf.

⁹⁷ WB in transition, 2006.

Figure 2.4 Consumer price index, producer price index, core inflation, %, 1995-2006



Source: WIWW, Croatian National Bank (core inflation)

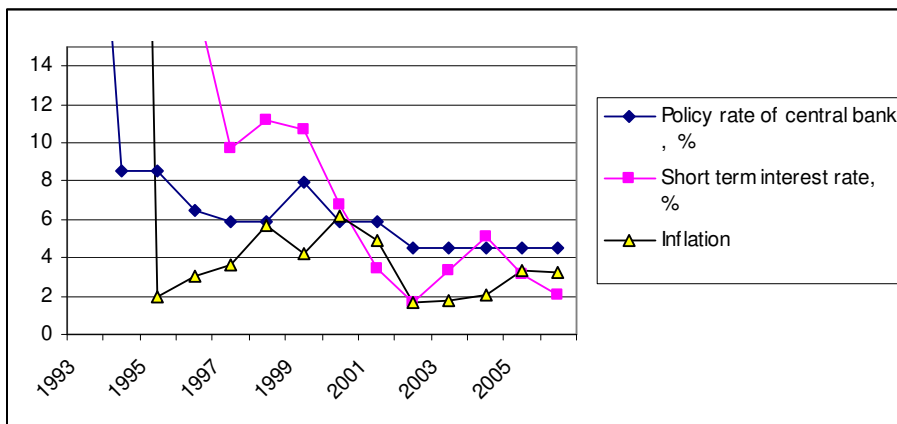
Table 2.5 Interest rates (official, market rates)

	The policy rate of the Central Bank, %	Short term interest rate, %	Long term interest rate, %
1990	-	-	-
1991	-	-	-
1992	-	951.2	-
1993	34.5	1370.5	-
1994	8.5	26.9	-
1995	8.5	21.1	-
1996	6.5	17.6	-
1997	5.9	9.7	-
1998	5.9	11.2	-
1999	7.9	10.7	-
2000	5.9	6.8	-
2001	5.9	3.4	-
2002	4.5	1.7	-
2003	4.5	3.3	-
2004	4.5	5.1	-
2005	4.5	3.1	-
2006	4.5	2.1	-

Source: WIWW, IMF

The 1993 data show extremely high interest rates and a large interest spread because the expectations of the market participants did not adjust immediately after the exchange rate and price stabilization occurred in November 1993. The nominal interest rates decreased in 1994 due to the rising credibility of the ongoing programme and due to price deflation (real lending interest rates in 1994 were strongly positive, amounting to more than 18%), and then they increased again in 1995, mainly due to a rise in the inflation (real interest rates rose only marginally compared to 1994). However, it is the interest rates spread that rose significantly in 1995. According to Šonje, Kraft and Dorsey (1996), this was due to the very high and growing overhead administrative expenses in banks, and the costs of the exchange rate volatility that were passed on to clients.

Figure 2.5 Trends in the policy rate of the central bank, short term interest rate, and inflation, 1993-2005



Source: WIW

Following the stabilisation programme in 1993, the interest rates were decreasing. However, the policy rate of the Central Bank, inflation and the short-term interest rate did not follow the same trend during the whole period.

2.2.2.2 Exchange rate

At the end of 1991, the Republic of Croatia introduced the Croatian Dinar at the exchange rate 1 convertible Dinar = 1 HRD. In May 1994, a new monetary unit called Kuna was introduced at the exchange rate 1 000 HRD = 1 Kuna.

The legal basis for Croatia's foreign exchange regime was the Law on the Foundations of the Foreign Exchange System, effective since 19 October 1993. The Law regulated the

foreign exchange market, in which all purchase and sale of foreign exchange took place. The exchange rate of the Kuna is determined by the supply and demand in the interbank market, with the significant participation of the Croatian National Bank.

Croatia opted for a floating exchange rate for its national currency, the Kuna, pegged to the Deutsche Mark, and from 1 January 1999 to the Euro, to enable the economy to adjust to external shocks. Measured at the average monthly HRK/EUR exchange rate, fluctuations have been within a narrow $\pm 4\%$ band during the period 2001-06.

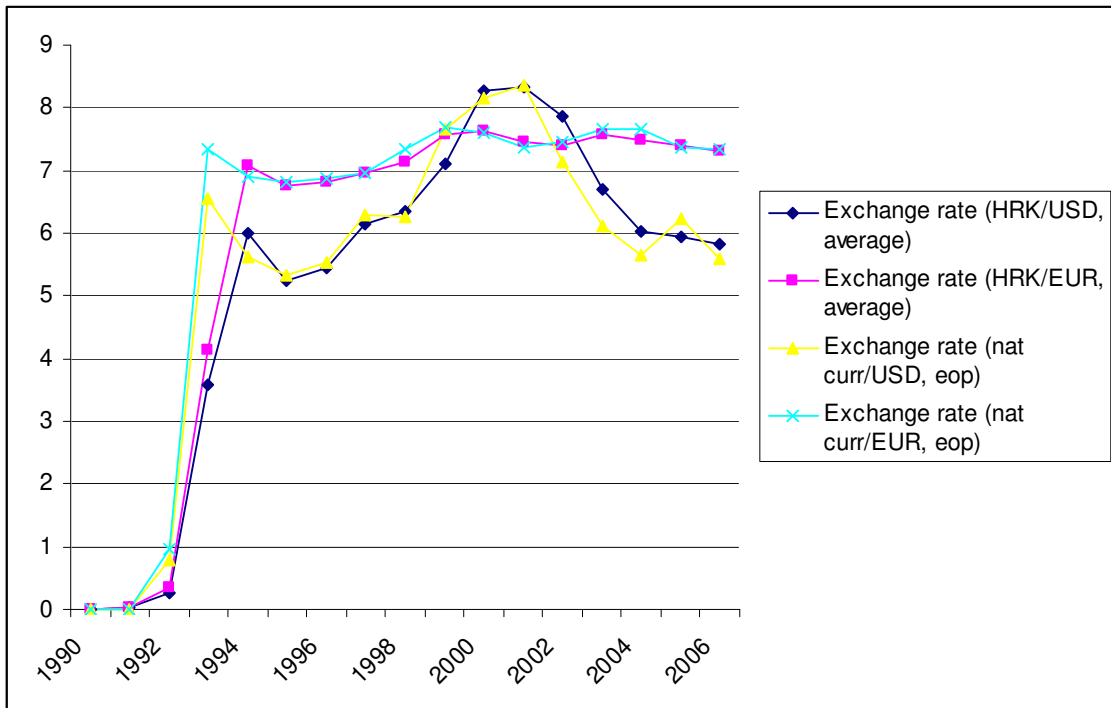
The tolerance of the CNB for exchange rate movements has been relatively low and intervention quite systematic. In this regard, it is interesting to compare Croatia with other transition economies with similar exchange rate arrangements, like the Czech Republic, Slovakia, Slovenia, Romania — all, like Croatia, "managed floats" in the IMF classification scheme — and a soft "peg" one like Hungary. While the latter three have a history of continuous depreciation since 1994 (largely managed in the case of Slovenia and Hungary), the Croatian currency, like that of the Czech Republic and Slovakia, has been fairly stable over time and even within this group its movements have been remarkably smooth. Croatia displays by far the most inflexible exchange rate.⁹⁸

The authorities' exchange rate policy regarding the Kuna is managed floating with no pre-announced path for the exchange rate, and the float has been tightly managed. The National Bank of Croatia is authorized to intervene in the foreign currency market to maintain a competitive exchange rate. The Central Bank alleviates the appreciation pressures coming from the strong capital inflow and tourism revenues through interventions on the foreign exchange market. The Croatian National Bank transacts only in Euros, US dollars and SDRS. Exchange rates are published daily by the authorized banks and the National Bank of Croatia.⁹⁹

⁹⁸ Andreas Billmeie and Leo Bonato, Exchange Rate Pass-Through and Monetary Policy in Croatia. *IMF working paper 02/109*, (IMF, 2002).

⁹⁹ Report of the working party on the accession of Croatia to the world trade organization, (2007), 3 <http://www.wto.org/>.

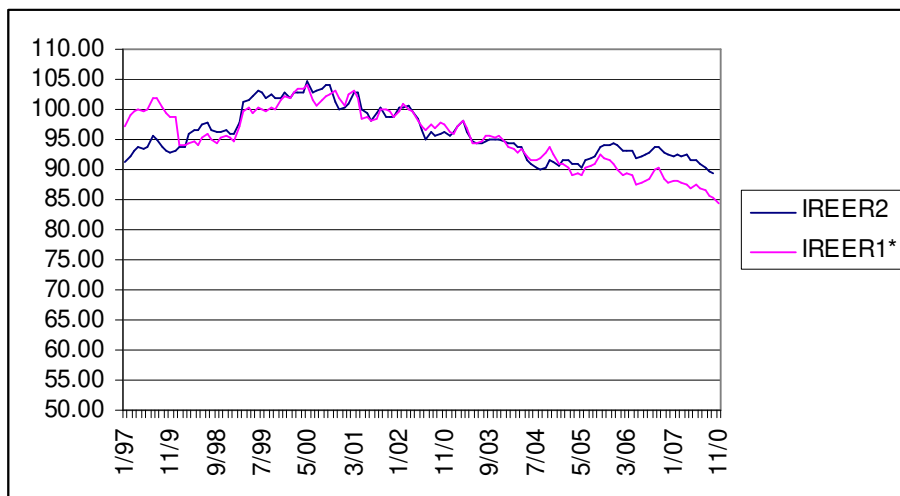
Figure 2.6 The development of exchange rates



Data source: WIIW, Croatian National Bank

IRRER1 is deflated by the consumer price index, 2001=100. Until December 1997, instead of the consumer price index, the retail price index was used.

Figure 2.7 The index of the real effective Kuna exchange rate, CPI (IREER1) & PPI (IREER2), 2001=100



Source: Croatian National Bank

2.2.2.3 Ratings

At the end of 1996, three global agencies for the evaluation of credit rating initiated the process of the Republic of Croatia's credit rating evaluation.¹⁰⁰ Croatia requested a credit rating from the agencies Standard & Poor and IBCA, while Moody's Investor Service initiated the process without an explicit request from Croatia. All three agencies were uniform in their evaluation of the Croatian credit rating, and at the beginning of 1997, they attributed an investment credit grade rating to Croatia.

Verification in 1999 resulted in the confirmation of the investment credit rating by Moody's Investor Service, Standard & Poor's Corporation and the Japanese rating agency R&I, whereas the British rating agency Fitch IBCA placed Croatia into the group of countries with lower credit ratings, among the speculative credit ratings. In 2000, Moody's Investors Service, Standard & Poor's Corporation, and R&I confirmed the investment credit rating. Fitch IBCA left the Republic of Croatia in the group of countries with the highest speculative credit rating, but it changed the 'stable' outlook into a 'positive' one. Indeed, the verification of the awarded credit rating in 2001 resulted in an improved credit rating by the Fitch Rating Agency, which transferred Croatia from the group of countries with a speculative credit rating into the group of countries with an investment credit rating with a 'stable' outlook. Standard & Poor's rating confirmed the investment credit rating, but improved the outlook from 'negative' to 'stable', while other agencies (Moody's Investor Service and R&I) confirmed the previous investment grading rating.

In the period 2002-03, the improvement of the overall state of the economy, as well as the advancement of the balance-of-payments indicators resulted, besides the confirmation of the investment credit rating, in the change in the outlook from a 'negative' to a 'stable' one by the Standard & Poor's Corporation.

In 2004, Standard & Poor's increased the credit rating of Croatia from BBB- to BBB, which was the most important upgrade. The credit rating upgrade reflected the reforms and structural changes, as well as the stabilisation of the external debt level of the public and private sector. Moody's Investor Service, Fitch Ratings as well as Rating and Investment Information (R&I) confirmed the investment grade credit rating.

In 2006, Rating and Investment Information increased the credit rating from BBB to BBB+, while other agencies confirmed the previous rating.

¹⁰⁰ This subsection is based on Ministry of Finances, "Annual Reports of the Ministry of Finances, 1994-2006," <http://www.mfin.hr/str/73/>.

Table 2.6 Credit ratings attributed to Croatia, 1997- 2007

	Moody's			Standard & Poor's			Fitch IBCA			R&I
	Long term, Foreign Currency	Long term, Domestic currency	Short tem, Foreign currency	Long term, Foreign Currency	Long term, Domestic currency	Short tem, Foreign currency	Long term, Foreign Currency	Long term, Domestic currency	Short tem, Foreign currency	Long term, Foreign Currency
1997	Baa3	-	P-3	BBB-	A-	A3	n/a	n/a	n/a	BBB*
1998	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	
1999	Baa3	Baa1	P-3	BBB-	BBB+	A-3	BB+	BBB	B	BBB
2000	Baa1	Baa1	P-3	BBB-	BBB+	A-3	BB+	BBB	B	BBB
2001	Baa3	Baa1	P-3	BBB-	BBB+	A-3	BBB-	BBB+	F3	BBB
2002	Baa3**	Baa1	P-3	BBB-*	BBB+	A-3	BBB-***	BBB+	F3	BBB
2003	Baa3**	Baa1	P-3	BBB-*	BBB+	A-3	BBB-***	BBB+	F3	BBB
2004	Baa3**	Baa1	P-3	BBB**	BBB+	A-3	BBB-***	BBB+	F3	BBB
2005	Baa3**	Baa1	P-3	BBB**	BBB+	A-3	BBB-**	BBB+	F-3	BBB
2006	Baa3**	Baa1	P-1	BBB**	BBB+	A-3	BBB-*	BBB+	F3	BBB+
2007	Baa3			BBB			BBB-			

*JBRI (Japan Bond Research Institute) at the time, predecessor of Japan Rating & Investment (R&I), which was established in 1998.

** Stable outlook

*** Positive outlook

Source: Ministry of Finance, Annual Reports 1994-2007, available from <http://www.mfin.hr/str/73/>, Croatian National Bank (data for 2007)

2.2.3 Fiscal conditions

After a period of budgetary surplus (in 1994) and the relatively balanced fiscal policy during 1995 and 1996, the fiscal policy in 1997 can be defined as expansive. The agreements with the London and the Paris Club and the establishment of the Croatian investment credit rating enabled access to the international capital market. As a result, foreign borrowing increased 18 times from 1994 to 1997 (from HRK 43 million to HRK 3 726 million). Still, the fiscal deficits were kept relatively low, at or below three percent of the GDP until the end of the 1990s. Nevertheless, during this period, the country witnessed, in parallel, a dramatic expansion of the public sector spending from the independence (1991) to the end of the war (1995), partly due to the need to introduce a new layer of government and to the resources allocated to the war effort. The total consolidated general government spending grew from 39 percent of the GDP (1991) to 49 percent by the end of the war. This expansion was carried out despite a steep reduction of the pensions and the public sector wages immediately after the independence. This expenditure expansion continued throughout the post-war period, due to reconstruction activities, social spending linked to the war, and the government's inability to resist social demands aimed at rapidly recovering pre-war levels of consumption.

As a result, the size of the government, as measured by the ratio of consolidated general government expenditure to the GDP, expanded by more than 16 percentage points between 1991 and 1999. In 2000, the government started reducing expenditures in line with the IMF framework under the past Stand-by Arrangement (SBA), and the deficit of the consolidated central government (on an accrual basis) was reduced from 5.7% of GDP in 2000 to 5.4% in 2001. On the expenditure side, overall expenditure increased by 4.1% in 2001 compared to 2000, essentially due to transfers to the pension and health funds. The wage bill was even reduced by 3.8%, reflecting the wage freeze and the streamlining of the public wage coefficient grid.

On the revenue side, tax revenues increased by 4.2%. The VAT revenue remained the single most important revenue source and increased by more than 8%. For 2002, the central budget foresaw a rise in revenues by 4.2% over 2001, half of it coming from the VAT (+5.6%). Expenditure remained almost unchanged in nominal terms, thus dropping in real terms. The wage bill was set to fall by 2.7%. According to the Ministry of Finance, the

authorities aimed to achieve a deficit of the consolidated central government budget of 4.3% of the GDP, in line with the IMF programme¹⁰¹.

Fiscal consolidation continued through 2005 and 2006. According to the spring 2006 fiscal notification submitted by Croatia, the general government deficit declined from 5% in 2004 to 3.9% in 2005. According to the officially released budget data based on GFS, the general government deficit shrank from 4.9% to 4.2% of the GDP (GFS), which was in line with the adopted budget framework and with the policy targets set under the Pre-Accession Economic Programme and the precautionary IMF stand-by programme, which expired in November 2006.

Within the structure of total revenue, the most important ones are tax revenues, which in 2005 accounted for 59.2% of the total revenue. Social contributions follow with their share of 36.5% in total revenues, while the remainder refers to grants, property income, administrative fees, revenues under the special regulations and other revenues.

If the shares in the GDP of certain revenue categories are observed, it can be seen that the share of the total revenue in the GDP was almost constant in the period 2002-05. Namely, in 2002, the budgetary central government revenue accounted for 38.4%, 37.6% in 2003, while in 2004 it accounted for 37.8%. In 2005, the share of the total budgetary central government revenue in the GDP accounted for 37.4%, in line with the government's policy aimed at reducing the share of both revenue and expense in the GDP.

Compared to previous years, the 2005 share of the tax revenue in the GDP was moderately reduced. Namely, in 2002, the share of the tax revenue in the GDP accounted for 23.6%, in 2003, this share amounted to 22.8%, 22.2% in 2004, while in 2005 it accounted for 22.1% of the GDP. It can be concluded that a moderate trend of the reduction of the tax revenue share in the GDP is present. Social contributions recorded broadly the same share in the GDP over the years, although in 2005 this share was lower than the average of the past few years, but only by 0.1 percentage points. Other revenues, especially property income, depend on the specific circumstances in the different periods, so that the comparison of their share in the GDP is not representative.

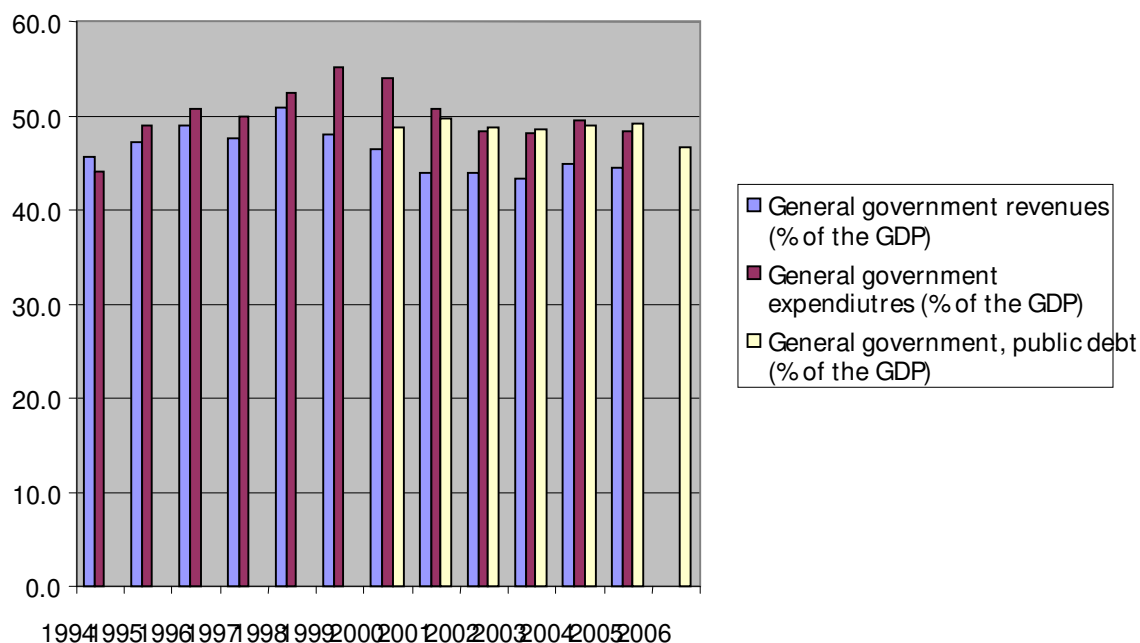
The fiscal consolidation years led to a stabilisation of the general government debt ratio at around 44% (ESA 95) at the end of 2005. However, if the issued guarantees as well as

¹⁰¹ The Western Balkans in Transition, *European Economy occasional papers*, no. 1 (2003), http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocp1en.pdf.

the outstanding debt of the state development bank, HBOR, is included, the total public debt amounted to around 53% of the GDP.¹⁰²

The 2006 budget framework provided for the further reduction of the general government deficit to 3% of the GDP (GFS). Revenues grew faster than spending, but the high external debt and the need for consolidation require an acceleration of the structural reforms, in particular in the area of health care, social welfare spending and state aid to enterprises.

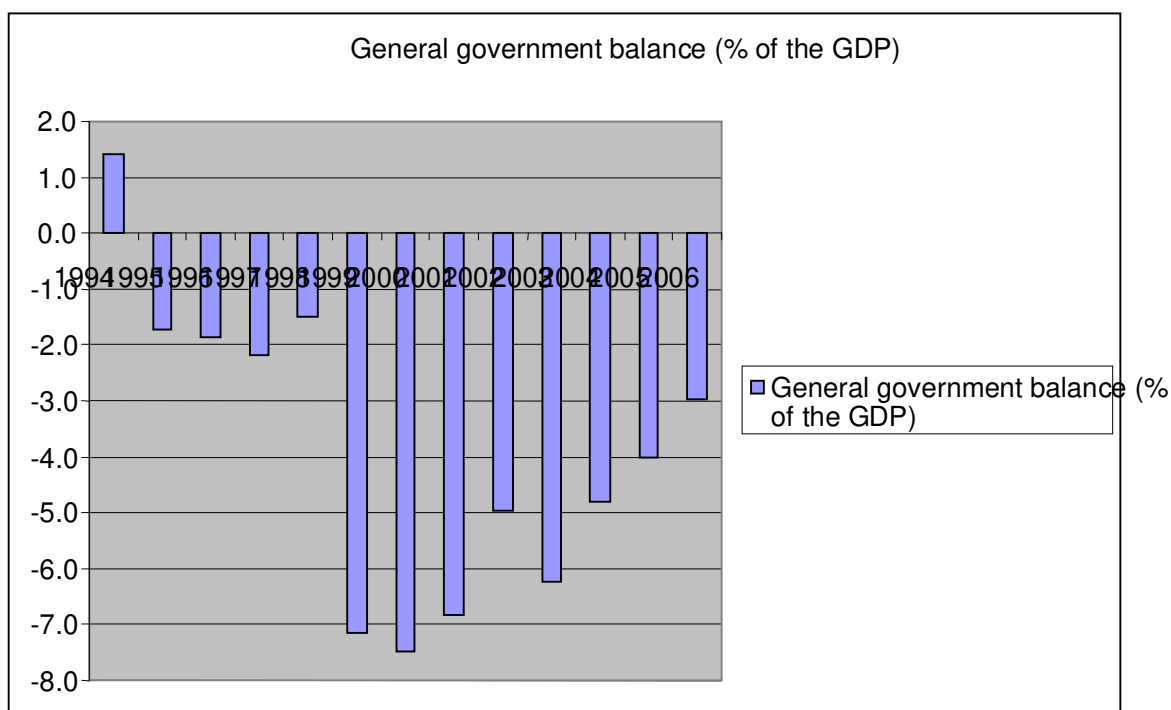
Figure 2.8 The development of revenues and expenditures



Data source: WIIW

¹⁰² Western Balkans in transition, 2006.

Figure 2.9 The development of the general government balance



Data source: WIIW, according to national definition

2.2.3.1 The development of public debt

According to the 2003 Budget law¹⁰³, government debt is defined as the debt of the consolidated government budget without government guarantees. With government guarantees added, government debt is defined as public debt. Table 2.7 illustrates the trend of the public debt of Croatia in the period 1999-2006.¹⁰⁴

In the early 1990s, a significant part of the public debt of Croatia emerged by taking over a part of the former SFRY debts (towards the London and the Paris Club, namely to the official creditors), or as a consequence of the disintegration of the former SRFY (frozen foreign currency deposits, JDA, JDB bonds). Until 1998, only a minor part of the total public debt was an original debt of Croatia.¹⁰⁵ The structure of the internal debt and the stock of dept are presented in Table 2.8.

¹⁰³ "Budget Law," *Official Gazette*, no. 96 (2003), <http://www.nn.hr/clanci/sluzbeno/2003/1216.htm>.

¹⁰⁴ The reports of the Ministry of Finance until 1999 did not present government guarantees.

¹⁰⁵ Ministry of Finances, "Annual Reports of the Ministry of Finances, 1994-2006," <http://www.mfin.hr/str/73/>.

Table 2.7 The development of public debt, 1999-2006, % of the GDP

Year	Public debt, % of the GDP
1999	42.3
2000	48.9
2001	50.3
2002	50.7
2003	51.1
2004	52.1
2005	52.8
2006	49.7

Source: Ministry of finance, Annual Reports, 1994-2006

Table 2.8 Stock of internal debt, 1991-96, end of the year, DM million

	1991	1992	1993	1994	1995	1996
1. Frozen foreign exchange deposits	5033.90	4653.61	3989.68	3245.91	2796.28	2382.75
2. Big Bonds	1055.09	1597.28	1420.03	1360.72	1301.42	1087.37
3. Bonds 93			107.37	89.48	53.69	17.90
4. Bonds 94-1				41.76		
5. Bonds 94-2					9.66	
6. Bonds JDA					153.70	128.08
7. Bonds JDB						147.10
8. Reconstruction Bonds			16.25	10.87	7.96	7.32
9. CNB I Loan		31.31	4.08	4.27	3.78	3.48
10 CNB III Land					100.33	54.44
11. Banks Rehabilitation Agency's Bonds						736.59
I Total						
Long term internal debt	6583.99	6282.2	5537.41	4758.86	4426.82	4565.03
II Treasury Bills						76.39
III Long term and short term debt	6583.99	6282.20	5537.41	4758.86	4426.82	4641.42

Source: Ministry of Finance, Annual Report 1994-1996, 62.

Frozen foreign exchange deposits were a major component of the internal debt in the period until 1997. Croatia ceased to be a part of the monetary system of the former SFRY in June 1991 by a decision of the former National bank of Yugoslavia. All business relations between the Croatian commercial banks and the former Central Bank were broken off. The

commercial banks could not realize their claims towards the National Bank of Yugoslavia related to the foreign exchange deposits of the citizens. Namely, the commercial banks in SFRY were liable to deposit foreign exchange funds in the National Bank of Yugoslavia and obtained in return the equivalent value in the former domestic currency (Dinar).

At the end of 1991, the government of Croatia issued a Decree on the Conversion of the Citizens' Foreign Exchange Deposits with Banks into the Public Debt of the Republic of Croatia.¹⁰⁶ Croatia issued its bonds to commercial banks, denominated in Deutsche Marks. With respect to the repayment of the first out of the 20 annuities of the principle of the frozen foreign exchange deposits, Croatia issued so-called JDA bonds. In the same manner, the payment of the second annuity for the principle of frozen foreign exchange deposits in 1995 was replaced by the issuance of JDB Bonds. The so-called "Big Bonds" issued in 1991 represent another major component of the internal debt. The bonds were issued to enterprises dealing with the economic infrastructure, exporting capital goods, performing investment works abroad, as well as to the manufacturers of basic agricultural products. Reconstruction bonds were issued during 1992 and 1993. The loans from the Croatian National Bank granted in 1991 and 1995 were repaid in total at the end of 1997, regardless of their longer maturities. Treasury bills are short-term securities by which the Ministry of Finance collected funds on the domestic money market.

As regards external public debt, in 1995 and 1996 Croatia finalised the negotiations with the member governments of the Paris Club and the commercial banks of the London Club. In accordance with the Agreement on the Consolidation of the Debt of the Republic of Croatia, the government took over the allocated debts¹⁰⁷ and 28.49% of the non-allocated debts of the former SFRY. By reaching an agreement with the members of the Paris and London Clubs, the basis for emerging on the international capital market was accomplished.

After negotiations held with a number of international banks, the Dresdner Bank Luxembourg was appointed as the Leading Bank of the International Syndicate Banks. Another 28 banks from 12 countries joined the syndicate, which provided DEM 200 million in 1996. In 1997, Croatia issued bonds denominated in Kunas in the amount of HRK 300 million, out of which HRK 150 million was issued on the domestic, and HRK 150 million on

¹⁰⁶ Decree on the Conversion of the Citizens' Foreign Exchange Deposits into the Public Debt of the Republic of Croatia, *Official Gazette* no. 71 (1991), no. 3 (1992), no. 12 (1992), no. 71 (1992), no. 58 (1993). In November 1993 Law on the Conversion of the Citizens Foreign Exchange Deposits into the Public Debt entered into force *Official Gazette*, no. 103 (1993).

¹⁰⁷ The allocated debts were contracted or guaranteed by legal entities resident in Croatia.

the international market. The Inaugural Eurobond denominated in USD in the amount of USD 300 million was also issued in 1997.

Croatia joined the IMF in 1992, and the IBRD and its affiliations (IFC, IDA; MIGA) in 1993. It took over 29.38% of the former SFRY share in the capital of the World Bank group and 7.6% of the debts towards the IBRD, according to the territorial principle. The total inherited debt of Croatia incurred by inherited loans amounted to USD 160 million and in the period 1993-97, the IBRD approved USD 312 million for 10 projects.

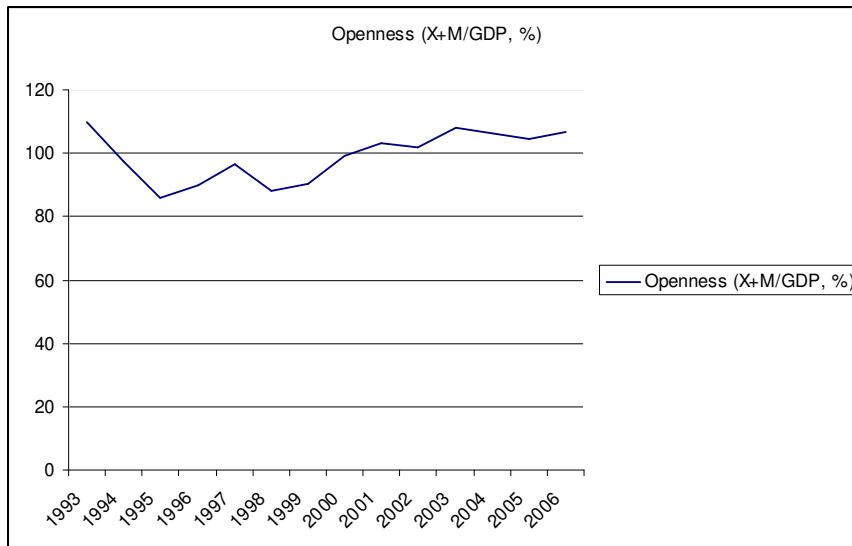
In 1993, Croatia became a full member of the EBRD, and by 1997, the EBRD approved 17 loans in total for Croatia in the amount of DEM 498 million and USD 40 million. The EIB, by the end of 1997, approved ECU 148.922 million for six projects. Croatia also inherited 23 million of the debt to the Council of Europe Social Development Fund, while the formal application to CEF was submitted in 1996.

2.2.4 Trade developments

The volume of trade, i.e. the changes in market share, the structural changes of an export sample, and the redirection of exports towards more demanding markets are some of the indicators that are used to measure level of competitiveness. Openness, in line with the traditional theory, is related to the allocation of resources. Thus, it is not surprising that in the period 1993-95, when openness was decreasing the export of goods was stagnating¹⁰⁸

¹⁰⁸ Ana-Maria Boromisa and Mia Mikić, "The European Union as determinant of Croatian trade policy," in *Croatian accession to the European Union: Economic and Legal Challenges*, ed. Katarina Ott (Zagreb: Institute for Public Finances : Friedrich Ebert Stiftung, 2003), 139-157, <http://www.ijf.hr/eng/EU/boromisa-mikic.pdf>.

Figure 2.10 Openness of the country

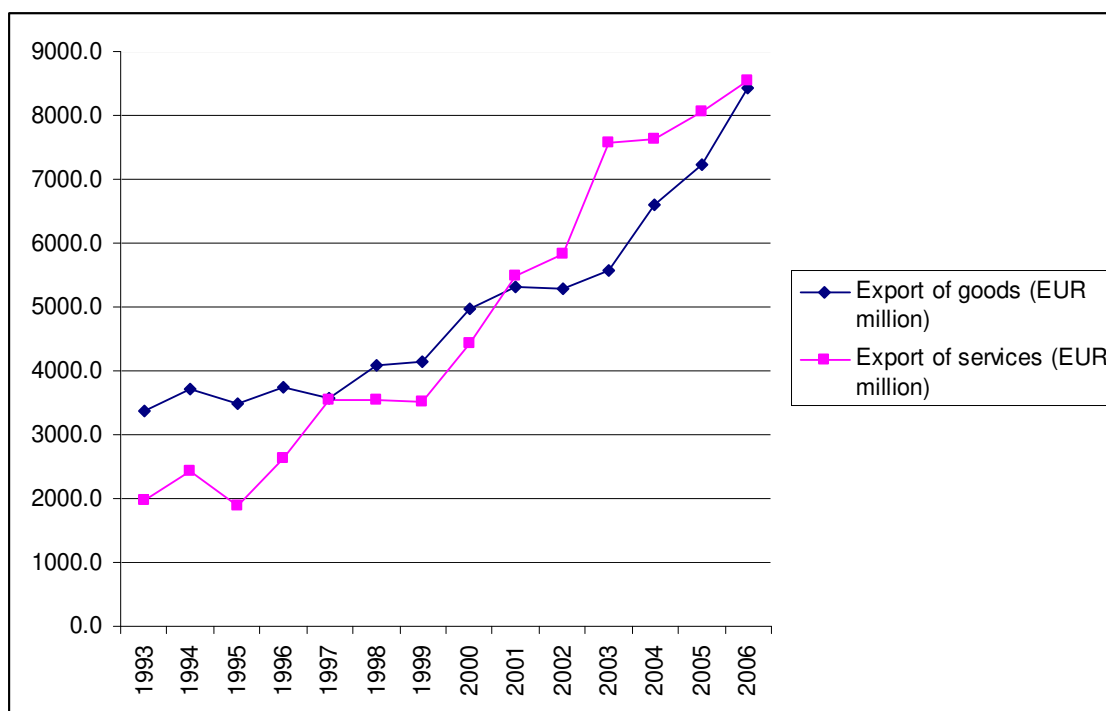


Source: WIIW

The increasing openness in the period that followed had limited economic effect as regards Croatia's export performance. The stagnation of the exports of goods continued until 1999, which can be attributed to a number of factors. First of all, Croatia's export structure remained largely unchanged, i.e. the domination of the former and the current public enterprises (in particular, shipbuilding with large import components), as well as the lack of significant FDI in the manufacturing sector continued. Furthermore, Croatian companies were often not able to apply the EC standards. The structure of exports has not changed significantly, and the main export products have remained mostly the same since the 1990s: ships and boats, textile products, wood and wooden products.¹⁰⁹ Croatia was slow in establishing contractual relations with the EU and in the creation of free trade agreements, and thus, it has not been included in the Pan-European System of Diagonal Accumulation of Rules of Origin.

¹⁰⁹ International Trade Centre. "Comtrade data for 1997-2005."(2007), <http://www.intracen.org/tradstat>.

Figure 2.11 Development of exports: goods and services, EUR million



Data source: WIIW

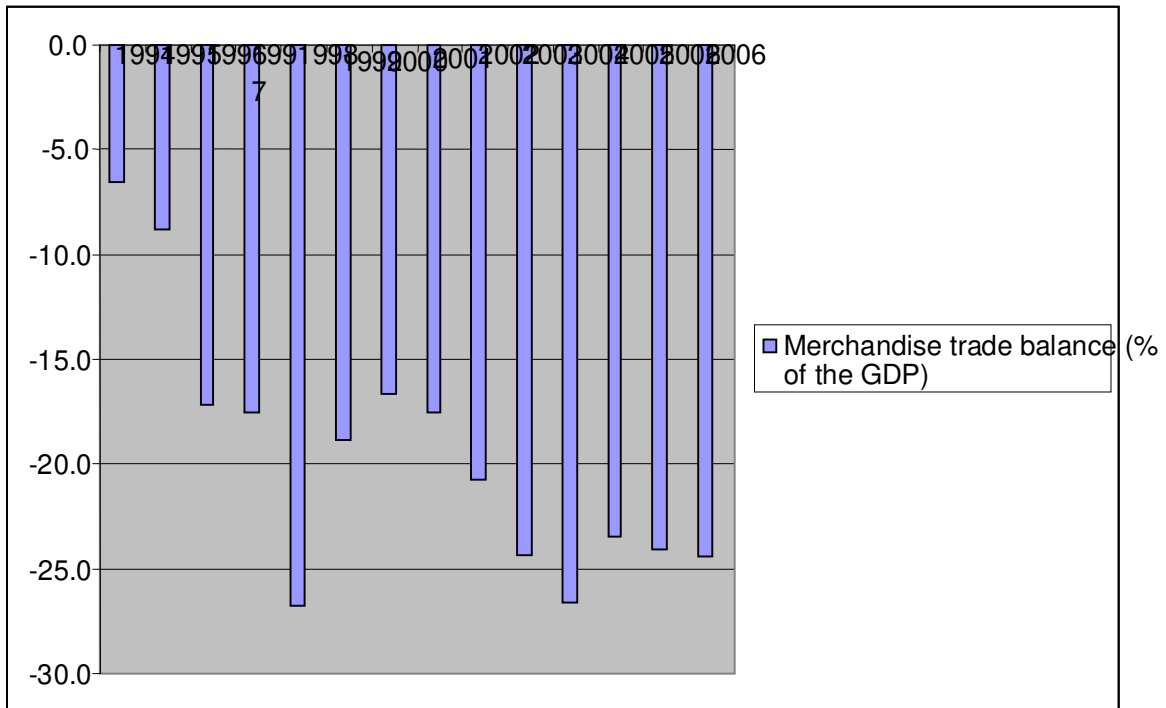
As a result of the increased imports, openness and the trade deficit increased. The steady export of services (mostly driven by tourism) has helped limiting the growth of the current account deficit.

Table 2.9 Development of the trade balance, million USD

	Trade deficit, total	Trade deficit, EU
1992	0.1	0.2
1993	-0.8	-0.4
1994	-0.9	-0.6
1995	-2.9	-2
1996	-3.3	-2
1997	-4.9	-3.3
1998	-3.9	-2.7
1999	-3.5	-2.3
2000	-3.2	-2.2
2001	-3.8	-2.2
2002	-5.8	-4.4
2003	-8.1	-6
2004	-8.6	-6.3
2005	-9.8	-6.8
2006	-11.2	-7.4

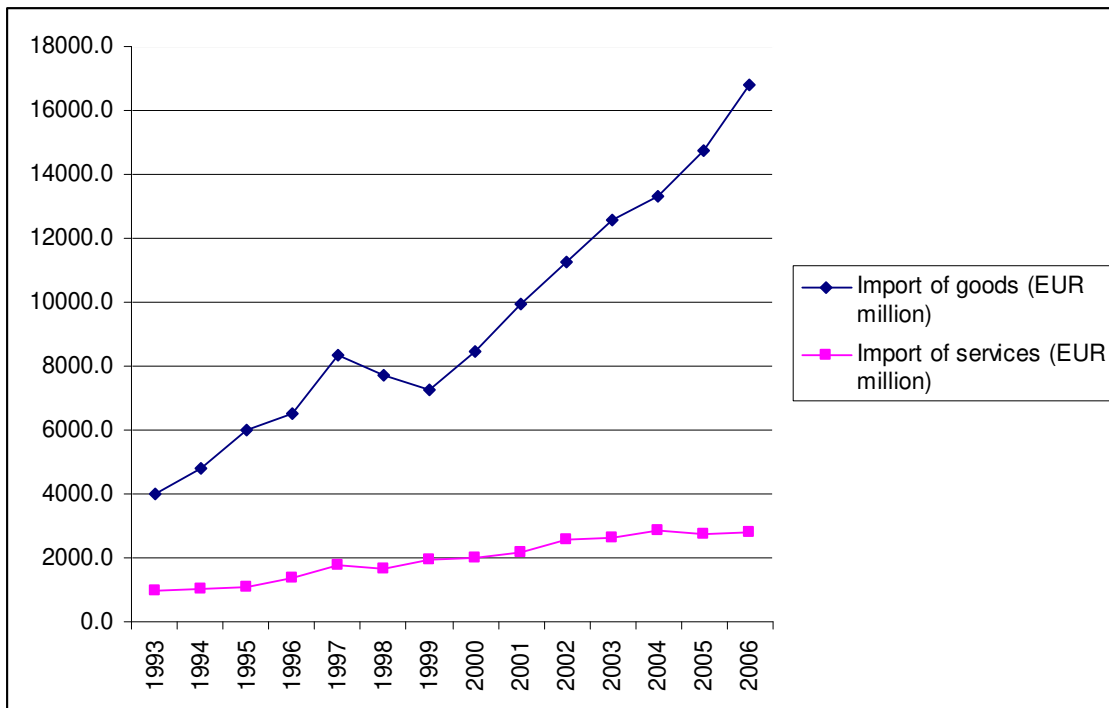
Source: Central Statistic Bureau

Figure 2.12 Development of the trade balance, % of the GDP



Data source: WIIW

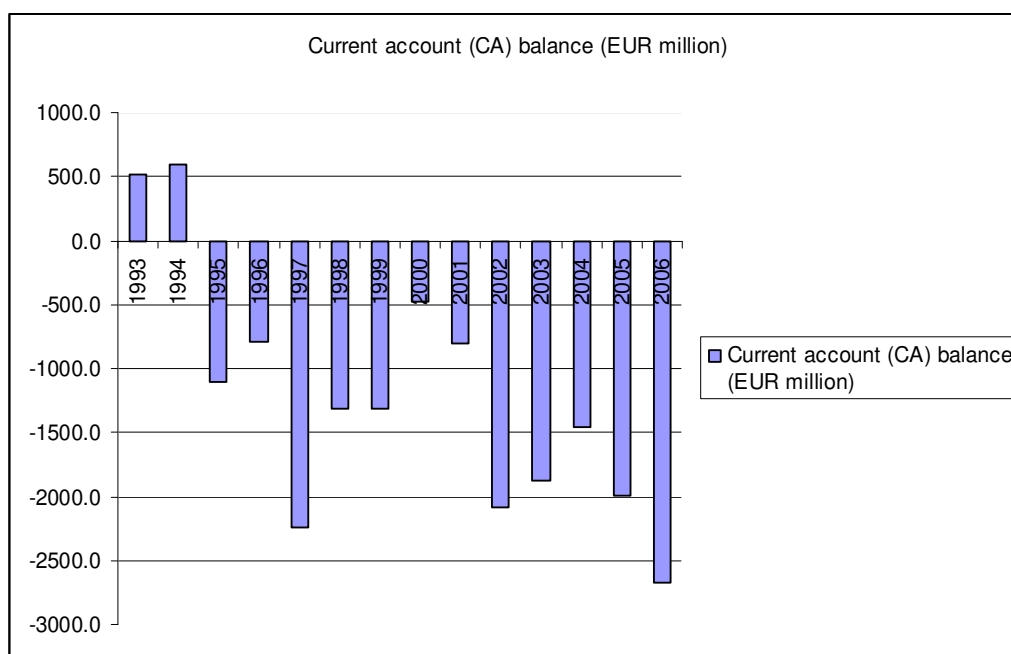
Figure 2.13 Development of imports, EUR million



Data source: WIIW

In spite of the decrease of the market share and the stagnation of the volume of the total exports to the EU until 2001, the EU has remained the most important market for Croatian products.¹¹⁰ In 2006, the share of the EU in Croatia's total trade was 66%, followed by Russia (6.6%), Bosnia and Herzegovina (6.2%), China (3.3%), and the USA (2.0%). The same is the ranking of Croatia's major import partners. Croatia exports the most to the EU member states (62.2% of the total exports), Bosnia and Herzegovina (14%), and the USA (3.2%).¹¹¹

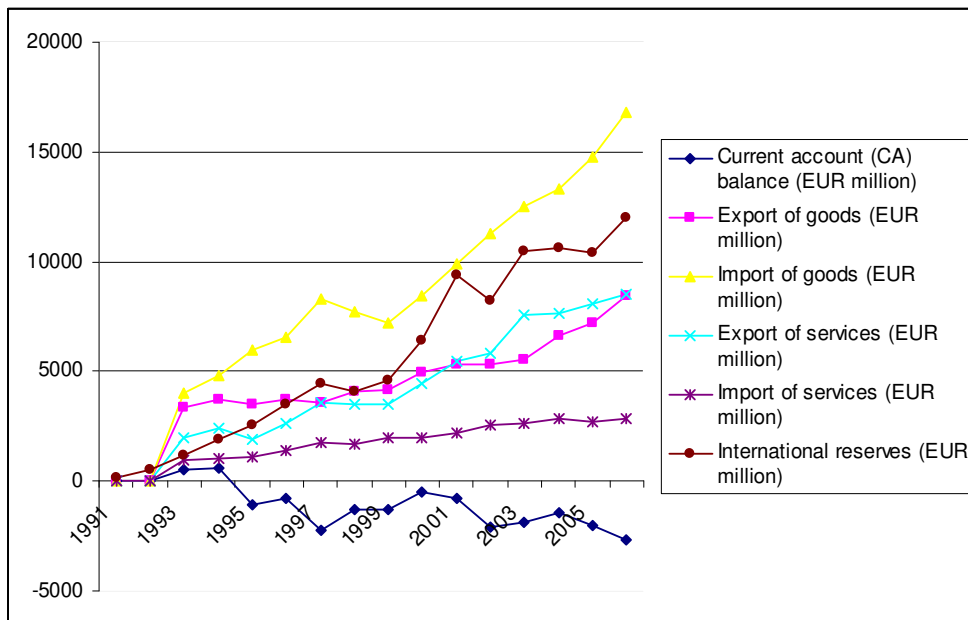
Figure 2.14 The evolution of the current account balance



¹¹⁰ For more about the Croatia-EU trade, see: Overview of Croatia –EU relation. http://ec.europa.eu/enlargement/candidate-countries/croatia/index_en.htm.

¹¹¹ European Commission, DG Trade, "Croatia 2007," http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113370.pdf.

Figure 2.15 The evolution of the main elements of the account balance



2.2.5 Factors affecting trade and current account developments

During the war, the output collapsed and restructuring was delayed. Tourism also suffered badly from the political instability. There were several reasons for the stagnation of the exports of goods until 1999: the unchanged export structure, the lack of FDI and the inability to apply the EC standards (e.g. slow transition). The lack of institutional links with the main partner countries and the exclusion from the Pan-European System of Diagonal Cumulation of Rules of Origin also did not help.¹¹²

Accession to the WTO in 2000 and the gradual establishment of the free trade zone represent the institutional conditions that facilitated access to most important markets. The agreements with the London and the Paris club and the establishment of the Croatian investment credit rating enabled access to the international capital market. The total deficit realised in 1997 can be observed as a turning-point in the fiscal policy position and a result of the government's capability to finance part of its needs on the international capital market under relatively favourable conditions.¹¹³ As a result, foreign borrowing increased 18 times from 1994 to 1997 (from 43 million Kuna to 3,726 million Kuna).

2.2.6 External assistance

2.2.6.1 Remittances

Croatia is considered to be a labour exporting-country, and the official working remittances (in million USD, real terms (see Table 2.10), are significant. Compared to Croatia's total export in the period 1994-2003, remittances range from 8 to 22%.

In the same period, Croatia experienced a stable inflow that increased every year. From the beginning to the end of the period, remittances more than tripled. The only exception is in the year 1999, when Croatia experienced a decrease in remittances from the previous period. This is probably due to the banking crisis and the recession in 1998, which lasted until the end of 1999. For the period 1999-2002, Croatia experienced its fastest rise in remittances. In 2004, remittances were estimated at 3% of the GDP. Compared to the capital flows, remittances have been the most stable source of capital to the domestic economy and far more significant than the official development finance.

¹¹² Western Balkans in transition.

¹¹³ Ministry of Finances, "Annual Reports of the Ministry of Finances, 1994-2006," <http://www.mfin.hr/str/73/>.

Table 2.10 Remittances received in Croatia, USD million, 1994-2007

Year	Remittances, USD million	Remittances EUR million
1994	349	
1995	544	
1996	668	
1997	617	512
1998	625	526
1999	557	480
2000	641	649
2001	747	783
2002	885	883
2003	1085	900
2004	1222	928
2005		933

Sources: Data in USD; Sources: Ali Mansoor and Bryce Quillin (eds) *Migration and Remittances* (World Bank, 2006), 125, available from http://siteresources.worldbank.org/INTECA/Resources/257896-1167856389505/Migration_Appendices.pdf, accessed on 20 December 2007; Data in Euro: Prpezinovic Adela, *Remittances and Income Inequality in Croatia*, Master's Thesis (Scholl of Economics and Management Lund University, February 2007), available from <http://biblioteket.ehl.lu.se/olle/papers/0002354.pdf>

2.2.6.2 Foreign aids and loans

The Law on Credit Relations with Foreign Countries regulates borrowing from international financial institutions and lending or borrowing arrangements with foreign partners by authorized banks, companies and legal entities, as well as guarantees issued for the account of domestic and foreign entities.

According to the CIA fact book, Official Development Finance (ODF) in 2005 reached USD 125.4 million, including assistance from the World Bank, the IMF, other international organizations, and from individual nation donors.¹¹⁴

¹¹⁴ Formal commitments of aid are included in the data. Omitted from the data are grants by private organizations. The CIA fact book data is calculated on an exchange rate basis, and it calculates the inflows of grants and loans and their repayment.

2.2.6.3 Relations with the main international financial institutions

Since gaining independence, Croatia has become a member of a number of prominent financial institutions. Here we present its cooperation with the IMF, the World Bank Group, the EIB and the Council of Europe Social Development Fund.

Croatia became a member of the **IMF** in December 1992, and it has benefited from IMF's technical assistance in key monetary, fiscal and public administration areas. An agreement was made with the new government in March 2001, culminating in a 14-month stand-by arrangement (SBA) for SDR 200 million (USD 255 million).¹¹⁵

Although all the performance criteria had been fulfilled, Croatia decided not to draw any funds in 1998. On 29 March 2002, the IMF completed the second review under the 14-month precautionary stand-by arrangement, which expired in May 2002. The authorities wanted to conclude a successor arrangement (also of a precautionary character). Such an arrangement, necessary for a credible policy of fiscal consolidation, was approved in 2003 and expired in 2004. The SBA amounted to SDR 105.88 million (about USD 147 million), and its aim was to stabilise the public debt ratio through fiscal prudence, whereas the review broadened the focus and underlined the need to contain the external current account deficit and the external debt. The subsequent IMF programme, agreed on in 2004, was also cautious, and it has proved useful in supporting the government's policies of macroeconomic stabilisation.¹¹⁶

From the last three stand-by arrangements (signed in 2001, 2003 and 2004), Croatia did not draw any funds, and the programme with the International Monetary Fund (IMF) was successfully completed in November 2006. The authorities did not request a successor arrangement. The transactions with the Fund in special drawing rights (SDRs)¹¹⁷ are presented in Table 2.11.

¹¹⁵ The Western Balkans in Transition, *European Economy occasional papers*, no. 3 (2001), http://ec.europa.eu/economy_finance/publications/european_economy/2001/c2001_03_en.pdf.

¹¹⁶ The Western Balkans in Transition, *European Economy occasional papers*, no. 5 (2004), http://ec.europa.eu/economy_finance/publications/occasional_papers/2004/ocp5en.pdf.

¹¹⁷ SDR is an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies. On 14 December 2007, SDR was 1.084 EUR. (www.imf.org)

Table 2.11 Transactions of Croatia with the IMF, from 1990-2007, SDRs

Year	General Resources Account (GRA)			Total		
	Disbursements	Repurchases	Charges Paid	Disbursements	Repayments	Charges/Interest Paid
2003	0	0	285,376	0	0	285,376
2002	0	97,231,667	2,565,822	0	97,231,667	2,565,822
2001	0	24,198,333	5,354,697	0	24,198,333	5,354,697
2000	0	21,800,000	6,947,321	0	21,800,000	6,947,321
1999	0	22,890,000	6,329,729	0	22,890,000	6,329,729
1998	0	6,540,000	7,955,667	0	6,540,000	7,955,667
1997	28,780,000	1,559,828	7,477,760	28,780,000	1,559,828	7,477,760
1996	0	3,119,656	6,555,543	0	3,119,656	6,555,543
1995	65,400,000	3,899,570	6,407,516	65,400,000	3,899,570	6,407,516
1994	78,480,000	6,239,312	830,283	78,480,000	6,239,312	830,283
1993	0	17,200,839	2,568,323	0	17,200,839	2,568,323
1992	44,328,984	12,309,779	0	44,328,984	12,309,779	0

Source: IMF,

http://www.imf.org/external/np/fin/tad/extrans1.aspx?memberKey1=227&endDate=2007%2D12%2D17&finposition_flag=YES, accessed on 17 December 2007

Based on the arrangements to take over the rights and liabilities inherited from the former SFRY, Croatia re-joined the **World Bank Group** in 1993 and took over 29.38% of the former SFRY share in the capital of the World Bank's group and took over 7.6% of the outstanding debts of the SFRY. In 1998, the World Bank opened its South Central Europe Regional Office in Zagreb, which covers Bulgaria, Romania and Croatia.¹¹⁸

In the period 1994-2006, the IBRD approved public loans for 21 projects (EUR 706 million, USD 576 million), and loans for nine projects with government guarantees (USD 81 million, EUR 234 million). The total loans reached USD 608.680 million and EUR 383.431 million.¹¹⁹

In the same period, 49 grant agreements were concluded, in the total amount of USD 35 million, JPY 270 million, GBP 352,800, EUR 11 million and SEK 23 million.¹²⁰

In November 2000, the general **European Investment Bank (EIB)** mandate 2000-07 was extended to lending to Croatia. The target amount for Croatia was EUR 250 million, but the final amount of lending to Croatia has been smaller. In the period 2000-06, a total of EUR 426 million was withdrawn.

¹¹⁸ The Western Balkans in Transition, *European Economy occasional papers*, no. 1 (2003), http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocpl.en.pdf.

¹¹⁹ Ministry of Finance, *Annual Report 2006* (2006), 148.

¹²⁰ *Ibid.*, 151.

Croatia joined the **European Bank for Reconstruction and Development** (EBRD) in March 1993. The EBRD had made a cumulative commitment of about EUR 1,600 million in Croatia, contributing to a total project value of some EUR 3 billion. About two thirds of the EBRD's portfolio was in private and one third in state projects.¹²¹

The Council of Europe Development Bank approved 11 public loans and 2 with government guarantees until the end of 2006, worth EUR 181 million and USD 4.5 million .

2.2.7 Foreign direct investment

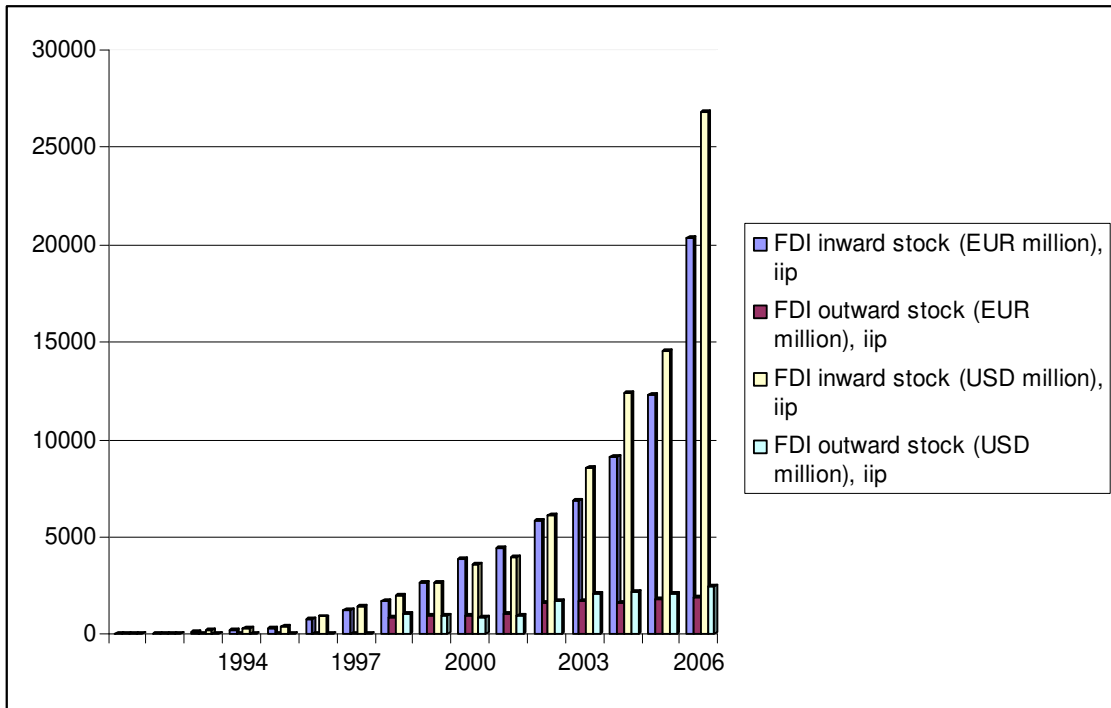
Foreign investment has been regulated under the Company Law, which entered into force on 1 January 1995. The Law defined a foreign investor as any foreign national or legal person with a registered seat outside the Republic of Croatia. The law from 1995 had nullified a number of restrictions on the foreign investment maintained under the previous legislation (the Law on Foreign Investments). No particular sector was closed to foreign investment. However, investments in the military industry and telecommunications were subject to a special procedure. According to the Law on Telecommunications, foreign investment in radio and television concessions was limited to 25 per cent of the capital of the concessionaire. Inward portfolio investment was not restricted, except for the Central Bank short-term securities in the primary market.

Foreign direct investment by non-residents could take the form of joint venture or full ownership. Registration with the commercial courts was required. National treatment applied to foreign investment in principle, on the condition of reciprocity. Amendments to the Company Law, abolishing the condition of reciprocity and thus providing full national treatment in respect of the establishment of commercial presence, was adopted by the parliament in March 1999, and entered in force following Croatia's accession to the WTO.

Concerning outward investments, Croatian residents were required to report their investments abroad to the Ministry of Economy ex-post for statistical purposes. The acquisition of real estate in Croatia by non-residents has been granted on the basis of reciprocity. However, before the accession to the WTO, foreign exchange restrictions in practice prevented Croatian residents from purchasing real estate abroad.

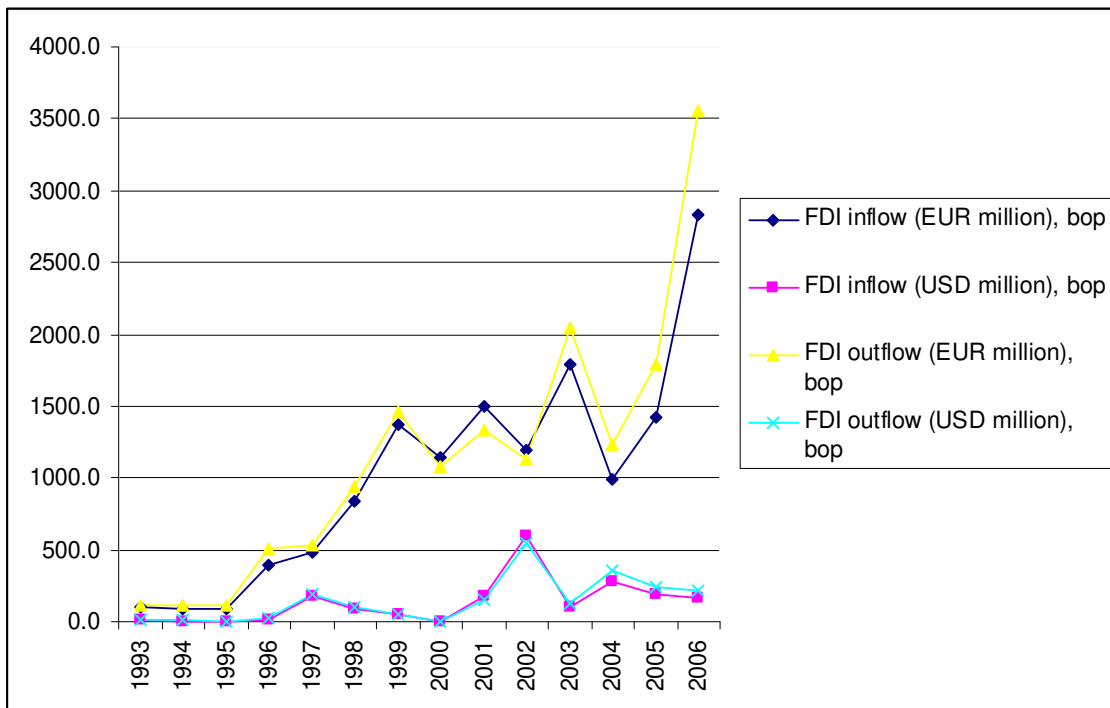
¹²¹ The Western Balkans in Transition, *European Economy occasional papers*, no. 1 (2003), http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocp1en.pdf.

Figure 2.16 Inward and outward FDI, stock



Source: WIIW

Figure 2.17 FDI inflow and outflow, 1993-2006



Inflows have been concentrated in few sectors. Just five industries have received more than 65% of the overall amount of FDI inflows: financial intermediation 31.1%, telecommunications 13.5%, chemical industry 14.0%, manufacture of coke and refined petroleum products 4.7% and gas and wholesale trade 4.1% of the total FDI inflows.

The first important FDI individual projects occurred in telecommunications and electronic industries (Ericsson, Siemens in 1995). The privatisation of banks followed: **while in 1996 foreign banks held 1% of the total assets, in 1999, this share increased to 39.9%, and in 2000 to 84.1%. Seven state-owned banks were privatised in 1999-2000. In 2002, three regional banks were privatised (Riječka, Dubrovačka and Splitska banks).**

Next was the privatisation of Croatian Telecom. **In October 1999, the government accepted the offer of Deutsche Telekom for the sale of 35% of Croatian Telecom for USD 850 million.** In mid-2001, an additional 16% stake in the Croatian Telecom Company (HT) was sold for EUR 500 million to Deutsche Telekom. The privatisation of another 19% was been postponed until 2007, when this share was sold following an initial public offering (IPO). In 2004, four privatisation projects in the telecommunication sector were completed, worth USD 42 million.¹²² The first stage of the privatisation of the oil company INA was finalised in 2003, and MOL, as a strategic investor, bought a 25%+1 share in the company.

In the period 2002-06, the total FDI into Croatia was close to the regional average (averaging just below 5 percent of the GDP annually during 2002-06), but greenfield FDI was well below the potential.¹²³

The uneven flow of FDI and the dominance of brownfield investments underline the need for improvements in the business and investment climate, or generally the need for structural reforms, which will increase the competitiveness of the overall economy and its attractiveness for investors, in particular, foreign investors.¹²⁴

¹²² World Bank, "Privatisation database," <http://rru.worldbank.org/Pri/atization/Results.aspx?countryid=52&startyear=2000&endyear=2006§ors=1,2,3,4,5,6>

¹²³ David Moore and Athanasios Vamvakidis, "Economic Growth in Croatia: potential and Constraints," *IMF Working Paper* (International Monetary Fund, 2007), <http://www.imf.org/external/pubs/ft/wp/2007/wp07198.pdf>.

¹²⁴ Central Office for Development Strategy and Coordination of EU funds, *Strategic Coherence Framework 2007-2013: Instrument for pre-accession assistance*, (Zagreb: Central Office for Development Strategy and Coordination of EU funds, 2006), 16.

2.2.8 Labour market developments

2.2.8.1 Labour market regulation

The Labour Law, replacing the Law on working relations (1992) and the Law on primary rights of employment (1991), was adopted in 1995 and entered into force in 1996. In 2001, it was amended twice, and once again in 2003.¹²⁵ Unlike the former changes, the change in 2003 directly referred to the level of the legislative protection of employment. The consolidated text of the Labour Law was published in 2004¹²⁶, and its latest change derives from the Decision of the Croatian Constitutional Court of May 2005.¹²⁷

The reform of the employment protection legislation in 2003 resulted in the significant reductions of the restrictions imposed by the legislation. The reform enjoyed strong support from various international institutions, so it was a structural benchmark in both the agreement with the World Bank on the Structural Adjustment Loan and the Stand-by arrangement with the International Monetary Fund. However, both the awareness of the necessity of the reform and the final results of the negotiations were outcomes of the dialogue within the domestic tripartite institutions. The case for the changing of the Labour Law was reinforced by the impression that it was considerably more restrictive than similar legislation in developed countries as well as in the neighbouring transition countries, thus making the creation of new jobs more expensive to the entrepreneurs, driving them into the sphere of the informal economy and discouraging foreign investors.¹²⁸

The changes introduced in 2004 define more precise criteria for concluding fixed-term contracts and dismissal. Some protection for whistleblowers was introduced. This provision can be regarded as support for fighting corruption. On the other hand, the minimum period for a regular notice was shortened and the minimum severance pay lowered (from one half to one third of the average monthly salary).

The 2004 Law also introduced a bargaining fee, i.e. the obligation for non-union workers to pay a fee throughout the period of the validity of the collective agreement, for the

¹²⁵ “Act on Amendments to the Labour Act,” *Official Gazette*, no. 114 (July 19, 2003),

<http://www.nn.hr/clanci/sluzbeno/2003/1574.htm>

¹²⁶ Teo Matković and Iva Biondic, “Reforma zakona o radu i promjena EPL indeksa,” *Financial theory and practice* 27 (2003), 515-528.

¹²⁷ “Odluka Ustavnog suda Republike Hrvatske, broj:U-I-2766/2003 i dr. od 24. svibnja 2005,” *Official Gazette*, no. 68 (2005).

¹²⁸ Vedran Šošić, “Poverty and Labor Market Policies in Croatia,” *Financial theory and practice* 29 (2005), 55-73.

benefits negotiated by the collective agreement. However, this provision was abolished by the Constitutional Court in 2005.

In order to help fighting the high unemployment, the establishment of temporary employment agencies was enabled. A temporary employment agency is an employer who, under a worker assignment agreement, assigns workers to another employer for the performance of temporary work. Temporary employment agencies have the role of mediators during the process of employment. They take care of the selection, administration, and registration of workers.

The adoption and implementation of the policies and the establishment of the relevant institutions are seen as essential steps for promoting employment.¹²⁹ Still, employment is a very challenging area for Croatia. Among all the EU member states, only Malta and Poland have lower total employment rates than Croatia, while the long-term unemployment rate is higher only in Slovakia and Poland. A high unemployment rate, in particular for the long-term unemployed and the young, and a low labour force participation rate, indicate that the labour market is not very flexible in Croatia.¹³⁰

2.2.8.2 Demographic composition and activity rate

According to the 2001 census, the Republic of Croatia had 4,437,460 inhabitants. Although the data are not strictly comparable, this represents a 6.1% fall in the total population compared to 1991 (based on the 1991 census definition). This is partly explained by a negative rate of natural increase, which is the effect of a long and steady decline in the birth-rate, which has fallen as low as 8.9 live births per 1000 inhabitants, while death rates have been stable in recent years. The share of people of working age in the total population is around 65%, and it will only start to decline after 2010¹³¹: according to the 1991 census, 70% of the men and 65% of the women were of working age (15-64). The share of this age group remained the same 10 years later, but the share of children decreased from 20% (boys) and 18% (girls) to 18% and 16 %, respectively.¹³²

¹²⁹ Ibid., 16.

¹³⁰ International Monetary Fund, "Republic of Croatia: Selected Issues, February 2007," *IMF Country Report* no. 07/82, http://www.informest.it/docs/documenti/HR_20070319105356_IMF_Selected07.pdf.

¹³¹ Sandrine Cazes, Alena Nesporova, Deniz Sertcan and Françoise Kempf, *Employment Policy Review Croatia*, (ILO, 2006).

¹³² Own calculations based on the DZS data.

The main determinant of demographic trends in Croatia, however, is migration. After a wave of emigration from Croatia to Western Europe at the beginning of the war, there was a large inflow of Bosnian refugees into Croatia when the war broke out there. In recent years, however, a positive migration balance has systematically set off the negative natural decrease. Increasingly, migrants arrive in order to work in Croatia: the number of work permits issued to foreigners has risen from about a fifth of the total immigrants in 1999 to almost a half in 2003. Migrant workers are predominantly male blue collar workers originating from the former Yugoslavia, although the share of college graduates is increasing.

The share of the active population decreased from 45.3% in 1991 to 43 % in 2001. The activity rate was decreasing in the period 1996-2000, from 56.2% to 50% and was about 50% until 2004, when it started growing and reached 62.6% in 2006. There is a significant gender gap: the activity rate of males in the period 1996-2003 ranges between 57% (in 2001) and 65% (1996), while the activity rate of females was below 50% during the whole period, ranging between 42% (2001) and 49% (1996). Young people between 14 and 24 have the highest unemployment rate, i.e. 28%, which is significantly higher than the total unemployment rate of 11.2% in 2006.

2.2.8.3 The development of employment

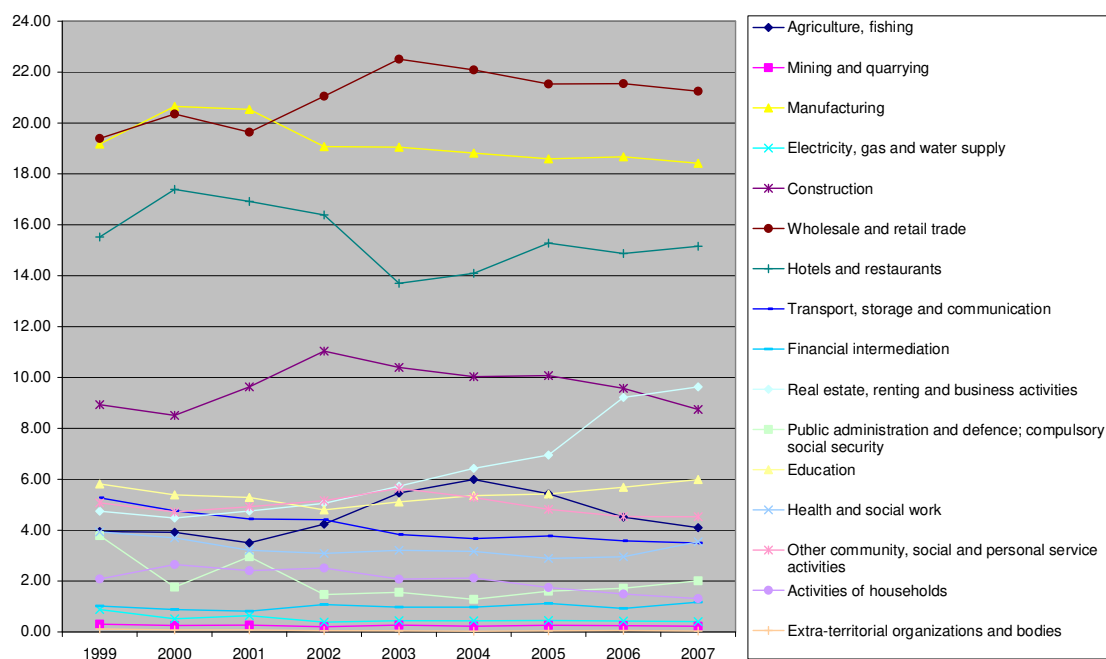
According to the labour force survey, Croatia had 1,536,500 employed inhabitants in 2003, which represents 83.6% of the 1989 figure. Today, employment rates are at a very low level compared with most East and South-East European countries, and they displayed a declining tendency throughout the 1990s. From 50.6% in 1996, employment fell to a low of 41.5% of the working age population in early 2001, before stabilising and reaching 43% at the end of 2003.

As with the activity rates, employment rates are very unequal with respect to gender. While the male employment rate reaches 50.3%, only 36.5% of working age women are employed, with particularly low rates for older women. The downward trend in employment has been quite evenly spread across the age groups, with the exception of workers between 50-64 years of age, whose employment rate has remained constant.

The pattern of employment in different sectors of economic activity in the period 1991-2006 roughly followed the general development trends in these sectors, i.e. a shift from employment in the industry and agriculture to services can be observed. The share of renting and business sector in the total employment doubled (from 4.8% in 1999 to 9.6 in 2006),

while the share of employment in the transport, storage and communication sectors decreased from 5.3 to 3.5%. There was also a significant decrease in the share of public administration and defence and compulsory social security in the total employment, from 3.8 to 2.1%.

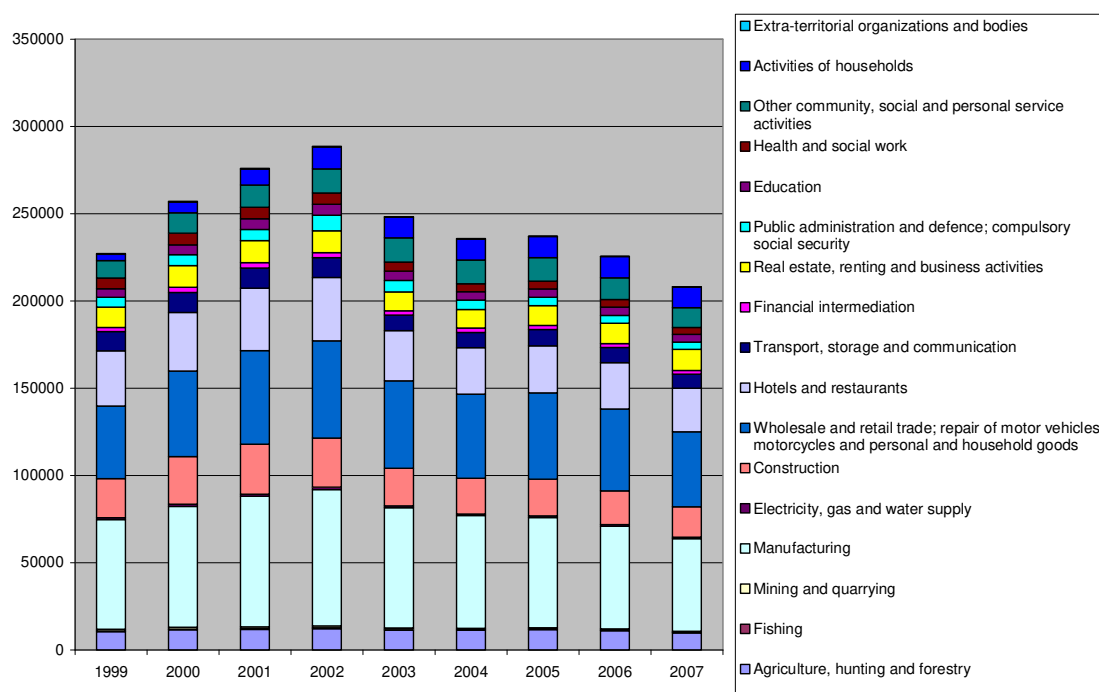
Figure 2.18 Shares of individual sectors in the total employment



Data source: Croatian Employment Office

While the main loss of industrial employment occurred as early as the beginning of the 1990s, agriculture continues to lose workers, while services keep gaining them. The single sector of strong growth was construction, which increased its workforce by about 30% between 1996 and 2003, partly thanks to public infrastructure projects.

Figure 2.19 The development of employment by sectors



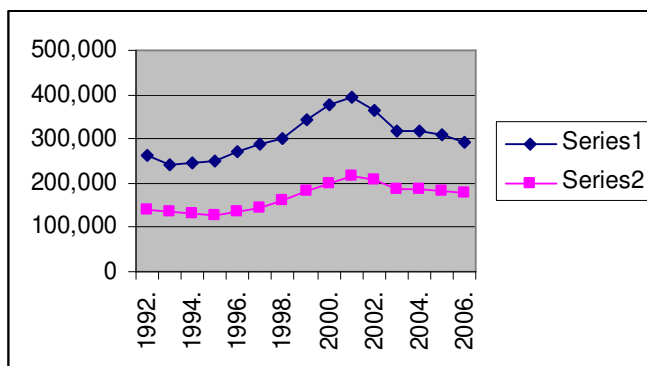
Employment in small and medium enterprises increased by 29% between 1995 and 2003, in contrast to the slight overall decrease in employment over the same period. This indicates a sizeable shift from large enterprises to SMEs. The proportion of workers employed in SMEs out of the total employment is now 38%.

2.2.8.4 Unemployment

From low levels, unemployment started increasing in 1991. It then remained constant at around 8% for some years, and in 1996, it started to rise steadily until it reached a peak of 17% in the second half of 2000. Sound economic growth and some systematic changes including stricter eligibility rules for the unemployed resulted in a gradual decrease of the official unemployment rate, which reached 14.4% in 2003.

Registered unemployment diverges systematically from the labour force survey results, showing significantly higher unemployment rates. The official unemployment rate was increasing in the period 1994-2001, from 14.1 to 23.1%; at the same time, the 2003 labour force survey places the number of unemployed in Croatia at 256,000, which represents an unemployment rate of 14.3%, while registered unemployment stood at 19.2%.

Figure 2.20 The development of unemployment between 1992-2006, total (series 1), females (series 2)



Source: Croatian Employment Office (HZZ), available from <http://www.hzz.hr/default.aspx?id=4713>

The officially registered unemployment rate in 2005 was 16.8%, while the labour force survey estimate is 13.1%. In 2006, according to the labour force survey, unemployment was 11.8%.¹³³ A decline in the unemployment rate has also been observed by the Employment Office and the Pension Insurance Fund. Still, the data on employment growth diverge: while the Employment Office estimates employment increase to be 0.6 year-on-year, the data of the Pension Insurance Fund suggests a stronger employment growth of above 3% on average in 2006.

Female unemployment is about 20% higher than the rate for men, and the gender difference holds across the age groups. The unemployment trends for different age groups are similar to the trends of the total unemployment, although the levels of unemployment rates differ enormously. While the prime age workers (25-49) have a slightly lower than average unemployment rate of 12.6%, and older workers have a comparably low unemployment rate of 8.9%, young people have an alarmingly high unemployment rate of 35.9% according to the LFS. However, older workers' share of the total registered unemployment has also grown quite dramatically, from 5.7% in 1990 to 20.7% in 2004.

The duration of unemployment is a matter of particular concern in Croatia. In 2003, 32% of the unemployed had been looking for a job for less than half a year, and another 13.1% had been unemployed for up to a year. This group of short and medium-term unemployed tends to have a higher level of qualification than the long-term unemployed. 13.9% of the labour force had been unemployed for between one and two years, while an

¹³³ "Western Balkans in Transition," *European Economy enlargement papers*, no. 30 (2006), http://ec.europa.eu/economy_finance/publications/publication1481_en.pdf.

alarming 39.4% had been unemployed for more than two years. The latter figure appears even more menacing if its development over time is taken into account. While the share of long-term unemployment up to two years in the total unemployment has been fairly constant, unemployment lasting for over two years has increased from 26.5% in 1996 to 39.3% in the second half of 2003. This means that once people become unemployed, they increasingly tend to remain so.

A breakdown of the unemployed population by occupation reveals that the single largest occupational group among the unemployed is service workers and shop and market sales workers' group, which represents 17.9% of the unemployed. This occupational group also has shown the strongest increase in unemployment over the last decade. Yet there are even more unemployed workers who have never worked before (33.2% of the total unemployment). The two sectors of activity generating the most unemployment are manufacturing and trade (with a 15 % average for the period 1999-2007).

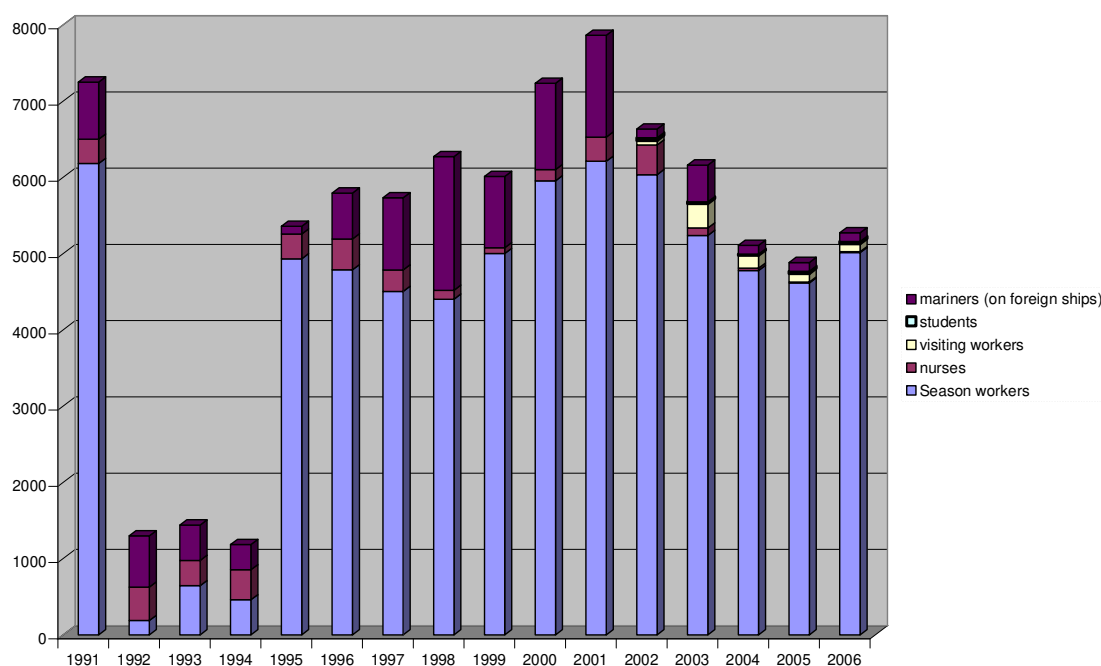
A comparison of the employment and unemployment structure by educational attainment shows that tertiary education considerably improves the labour market position of workers, while persons with a secondary education and in particular those with blue-collar professions are disproportionately hit by unemployment. Also, the demand for new labour reflected in the recruitment rates confirms this trend. The discrepancy between the low hiring rates of unskilled and semi-skilled workers and their seemingly better labour market position only reflects their low labour market participation, as many of them withdraw from the labour market after unsuccessfully looking for a job. The unskilled and low-skilled workers are also those who stand to gain most from a recovery of the labour demand.

The number of workers employed abroad (according to the Croatian Employment Agency) varied significantly in the period 1999-2006. After a significant drop in the period 1991-94, the average number of workers employed abroad in the period 1995-2006 was 6,026, peaking at 7,862 in 2001. Most of the workers employed abroad are seasonal workers, but since 2002, students have also appeared in the official statistics.¹³⁴

¹³⁴ E.g. According to the UNESCO statistics, in the period 1998-99 4600 students from Croatia were studying in Germany. Quoted according to the World Bank, "Migration and Remittances: Eastern Europe and Former Soviet Union", 182.

http://siteresources.worldbank.org/INTECA/Resources/2578961167856389505/Migration_Chapter2.pdf

Figure 2.21 Employment abroad



Source: HZZ, available from <http://www.hzz.hr/default.aspx?id=3996&proizv=1961>

The number of workers returning from abroad in 2006 was 3000, mostly returning from Germany, where they had spent up to four months.¹³⁵ The share of women in this group is 54%. According to Swiss data, the highly qualified migrants from Croatia are much affected by brain waste: more than 20% of migrants with tertiary education from Croatia are active in jobs requiring low skills (i.e. they are overqualified).

2.3 Structural developments

2.3.1 Monetary policy

2.3.1.1 Inflation factors and disinflation

An analysis of the driving forces of the inflation process in Croatia suggests that mark-up and excess money relationships, imposed as error correction terms, are the most significant variables for explaining the short-run behaviour of inflation. The GDP gap and the nominal effective exchange rate are also significant in explaining the short-run inflation dynamics. It seems that the Croatian inflation is much more responsive to deviations from the equilibrium

¹³⁵ Croatian Employment Office, "Return of workers from temporary work in foreign countries," <http://www.hzz.hr/default.aspx?id=3995&proiz=1962>.

on the supply side and to changes in the nominal effective exchange rate than to deviations from the equilibrium in the monetary sector. The Croatian consumer price inflation is affected by changes in the interest rates and import prices.¹³⁶

In the 1992-99 period, wage growth and currency depreciation had a positive and significant impact upon the inflation.¹³⁷ The evidence suggests that there were feedback effects from wage growth and currency depreciation to money growth. Likewise, past values of wage growth and currency depreciation had a positive impact on the current wage growth. Currency depreciation was affected by money growth and past values of currency depreciation. The relationship between money growth and currency depreciation is not surprising, given that since January 1994 the Croatian National Bank has followed (though unannounced) an exchange rate band wide enough to pursue a discretionary monetary policy to offset any adverse movements in the exchange rate triggered by capital flows. Moreover, the significance and importance of the nominal exchange rate as a factor in the inflationary process parallels the findings in the Czech Republic, Hungary, Poland, Albania and Slovenia.

2.3.1.2 Exchange rate regime

At the end of 1991, the Republic of Croatia introduced the Croatian Dinar at the exchange rate 1 convertible Dinar = 1 HRD. The Croatian Dinar was pegged to the Deutsche Mark and the nominal exchange rate ceiling was initially set to 4.444 HRD/DEM, although the exchange rate soon appreciated to 3.7 HK/DEM and later to 3.5 HRK/DEM, due to increased confidence in the domestic currency and the large capital inflow that followed. The exchange rate stabilised after the appreciation and was then backed by a 'dirty floating' regime, as the Central Bank decided to introduce more flexibility and pass on to a managed float. The legal basis for Croatia's foreign exchange regime was the Law on the Foundations on the Foreign Exchange System, effective since 19 October 1993. The Law regulated the foreign exchange market, in which all purchase and sale of foreign exchange took place.

By 1994, the foreign exchange reserves were already over USD 1 billion and were growing. The success of the stabilisation programme and the stability of the exchange rate

¹³⁶ Maruška Vizek and Tanja Broz, "Modelling Inflation in Croatia," *EIZ Working Papers* (2007), 1-22, <http://www.eizg.hr/AdminLite/FCKeditor/UserFiles/File/radni%20materijali%20EIZ-a-working%20papers-0703.pdf>.

¹³⁷ James E. Payne, "Inflationary dynamics of a transition economy: the Croatian experience," *Journal of Policy Modeling* no. 24 (3), (2002), 219-230.

encouraged the government to replace the Croatian Dinar in May 1994 with a new currency. The Kuna was introduced at the exchange rate 1 000 HRD = 1 Kuna.

A year later, current account convertibility was introduced, while the capital accounts restrictions were eased only much later, in June 2001. Croatia achieved a high level of price stability using the exchange rate as a nominal anchor. Since the mid-1990s, the defence of the exchange rate has been the central aim of the macroeconomic policy, and the Central Bank law defines price stability as the primary objective of the monetary policy. The exchange rate of the Kuna is determined by the supply and demand in the interbank market, with the significant participation of the Croatian National Bank. Measured at the average monthly HRK/EUR exchange rate, fluctuations have been within a narrow $\pm 4\%$ band during the period 2001-06.

The tolerance of the CNB for exchange rate movements has been relatively low and the intervention is quite systematic. In this regard, it is interesting to compare Croatia with other transition economies with similar exchange rate arrangements, like the Czech Republic, Slovakia, Slovenia, Romania — all, like Croatia, "managed floats" in the IMF classification scheme — and a soft "peg" one like Hungary. While the latter three have a history of continuous depreciation since 1994 (largely managed in the case of Slovenia and Hungary), the Croatian currency, like those of the Czech Republic and Slovakia, has been fairly stable over time and even within this group its movements have been remarkably smooth. Croatia displays by far the most inflexible exchange rate.¹³⁸

The authorities' exchange rate policy regarding the Kuna is managed floating with no pre-announced path for the exchange rate, and the float has been tightly managed. The National Bank of Croatia is authorized to intervene in the foreign currency market to maintain a competitive exchange rate. The Central Bank alleviates the appreciation pressures coming from a strong capital inflow and tourism revenues through interventions on the foreign exchange market. The Croatian National Bank transacts only in Euros, US dollars and SDRs. The Croatian National Bank is authorized to pass subordinate legislation and other enactments to regulate the foreign exchange operations of legal entities and natural persons and to perform foreign exchange control in Croatia. The Croatian National Bank is also authorized to

¹³⁸ Andreas Billmeie and Leo Bonato, "Exchange Rate Pass-Through and Monetary Policy in Croatia," *IMF working paper 02/109*, (IMF, 2002).

adopt methods for setting the value of the Kuna against other currencies. The exchange rates are published daily by the authorized banks and the National Bank of Croatia.¹³⁹

2.3.1.3 Monetary regime

One of the tasks of the Croatian National Bank is to formulate and execute the monetary policy. The Croatian National Bank may adopt the measures and instruments needed to regulate credit activity and the liquidity of banks and money supply, and to institute measures for the interest rates. For the purpose of implementing the established monetary policy, the Croatian National Bank may issue its own securities denominated in domestic or foreign currencies and may enter into agreements on purchasing, selling and exchanging securities and other readily marketable financial instruments, as well as the rights and obligations related to and arising from them.

The Croatian National Bank manages the international reserves in a manner which is best suited to the implementation of the monetary and foreign exchange policies and which ensures a smooth settlement of Croatia's international obligations. The Croatian National Bank may grant credits to solvent banks with a head office in the Republic of Croatia for periods not exceeding six months. The instruments of collateral that may be used for those loans include financial instruments as defined by the Law on the Croatian National Bank, debt instruments issued by the Croatian National Bank or the Republic of Croatia, payable in Croatia and constituting a part of the public issue, and debt instruments stipulated by the Law on the Croatian National Bank.

The interest rates for the discounts and loans of the Croatian National Bank are determined in a separate decision of the Croatian National Bank. The Croatian National Bank also obliges the banks to set aside and maintain reserve requirements in the settlement account and in the vault or in a separate account with the Croatian National Bank. Reserve requirements are defined as a percentage determined with regard to the type, maturity, and size of deposits, as well as the increase in the deposits and other liabilities of a bank. The decision on reserve requirements also provides a definition of the calculation base and the manner of calculating reserve requirements. The Croatian National Bank may choose to

¹³⁹ Report of the working party on the accession of Croatia to the world trade organization, (2007) 3 <http://www.wto.org/>.

remunerate banks for their reserve requirements set aside, where the amount of remuneration paid is prescribed by the Croatian National Bank.¹⁴⁰

The use of monetary policy instruments is determined by the exchange rate targeting framework of the monetary policy. There is no specified path or band for the exchange rate – the Croatian National Bank reacts to sudden changes in the exchange rate. This behaviour has resulted in a stable exchange rate. The exchange rate management is conducted mainly through foreign exchange interventions, which are the main instruments of the monetary policy.

The Croatian National Bank has been very active in managing domestic liquidity. Short-term interest rates are set on CNB's liability side by selling deposits. The reserve requirement has been the main instrument for managing domestic liquidity and monetary tightening. The short-term CNB bills are also used, which were the most important instruments in the period 2000-03. In 2005, the Croatian National Bank launched its regular open market operations: reverse repo operations are used to increase the system's liquidity. These are conducted every week (on Wednesdays), with a maturity of up to one week. Fine-tuning operations used to increase or decrease the system's liquidity are repo/reverse repo operations, and direct purchase/sale of securities. Structural operations, the direct purchase/sale of securities and repo/reverse repo operations are also conducted.

The three standing facilities in use are the deposit facility, which may be used on a daily basis and suspended by a discretionary decision of the CNB, lombard loan, and intraday loan. Other instruments used by the CNB include:

- Foreign currency auctions, held to protect the stability of the domestic currency and to maintain the liquidity of payments in the country and abroad, based on a discretionary decision of the CNB
- CNB bills
- Minimum required amount of foreign currency claims and
- Short term liquidity loans.

¹⁴⁰Croatian National Bank, <http://www.hnb.hr>.

2.3.1.4 Central bank regulations

The Croatian National Bank Act, adopted in 2001¹⁴¹ and amended in December 2006, governs the status, operations, ownership status, powers and organization of the Croatian National Bank, as well as the relationship of the Croatian National Bank with the Republic of Croatia, banks and international institutions and organizations. The Croatian National Bank has the authority to adopt subordinate legislation and other enactments regulating the foreign exchange operations of legal and natural persons. It also exercises control over foreign exchange operations in Croatia and has the authority to establish a method for setting the value of the Kuna against other currencies.

The Croatian National Bank is by definition autonomous and independent. The 2006 amendments increased the autonomy of the CNB and explicitly state that “The Croatian National Bank shall be independent in adopting and enforcing its decisions pursuant to this Act, and shall neither seek nor take instructions from the authorities of the Republic of Croatia, European Union bodies or other bodies. The authorities of the Republic of Croatia, European Union bodies or other bodies may not influence the independence of the Croatian National Bank or the decisions of the members of the Croatian National Bank Council, nor may they approve, revoke, postpone or cancel any decision taken by the members of the Croatian National Bank Council within its fields of competence.”

The amendments also provide for a secondary objective, which allows the general economic objectives of the European Community to take precedence over Croatia's domestic objectives. In addition, the rules and structures relevant to integrating the CNB into the European System of Central Banks by the time of the EU accession have been incorporated. The amended CNB Law more comprehensively prohibits the monetary financing of the public sector. The definition of "public sector" has been changed and now also includes extra-budgetary funds, local self-government units and other public bodies. The provisions that permitted the Croatian government to cover any shortfalls between the income and expenditure of the CNB that are larger than the CNB's general reserves, either from the state budget or by issuing bonds, have been revoked.

¹⁴¹ Previously the Bank Croatian National Bank Act (*Official Gazette* of the Republic of Croatia, no. 74 (1992), no. 36 (1993), no. 79 (1993), no. 29 (1994), no. 7 (1995) and no. 35 (1995) amended text.

2.3.2 Fiscal policy

2.3.2.1 The tax system

Immediately after its independence Croatia started a number of changes in the fiscal system: for example, the system of personal income tax was introduced in July 1990, war tax in September 1990 and excises in 1993. However, the changes made before 1994 resulted in a non-transparent system with extremely high effective tax rates.¹⁴² The period from 1994-97 was dominated by fundamental and technical changes in the tax system. The objectives of the reforms were the establishment of a system compatible with the market economy, the reduction of the tax burden, the increase of the efficiency of the tax administration, the enhancement of fiscal discipline, and increasing the efficiency of tax collection.

The Tax Administration was established in 1994, as an independent administrative organisation within the Ministry of Finance. The key elements of the Croatian tax system in the period 1994-2000 were the Law on Profit Tax, the Law on Income Tax and the Law on the turnover tax of products and services. The latter one was replaced by the Law on Value Added Tax on 1 January 2008.

Turnover tax was the most abundant revenue of the government budget till 1998. Its share in the total budget revenues amounted to 58.6% in 1994 and 45.6% in 1997, in the last year of its application. The reduction of the share of the turnover tax in the total revenues was enabled by the reforms of direct taxation and the introduction of excise taxes. In 1991, turnover tax was divided between eight tariff classes, with rates between 1% and 90%. The number of tariff classes was gradually reduced. In 1993, it was reduced to 7 and the general rate was decreased from 50% to 40%. Since July 1994, the number of tariff classes was further reduced to 5, and the tax rates were between 2.5 and 20% (the latter being the standard rate), for all products except one type of gas, which was taxed 60%. Since 1995, there have been 4 tariff classes and the last change in the sales tax rate was introduced in 1995, when the standard tax rate was reduced to 15%.

Since 1998, **value added tax** is the most important revenue of the state budget. The tax rates are 22 %, 10%, and 0%.

Other taxes in Croatia's fiscal system are: income tax, profit tax, tax on insurance premiums for cars, games of chance tax, real property transaction tax, inheritance and gift tax,

¹⁴² E.g. war tax was introduced on wages and other personal incomes, and all these impositions together with a special municipality tax resulted in a marginal tax higher than 90% of the highest incomes. The consequence of such a system was high tax evasion.

tax on motor vehicles, tax on boats, tax on slot machines for games of chance, consumption tax, tax on country cottages, tax on uncultivated agricultural land, tax on unused business immovable property, tax on inbuilt building sites, firm tax, tax on the use of public area, and local surcharges.¹⁴³

The system of **personal income tax** was introduced in July 1990, when a system of direct taxation on personal income was introduced, together with a tax on the total income of citizens. The tax was paid at the end of the year if the annual net income exceeded three times the amount of the average annual salary.

In 1994, a new personal income tax was introduced, based on consumption. The basic characteristics of this system were economic neutrality, fairness and administrative simplicity. As opposed to the previous system, where each type of income was taxed differently, the newly introduced system of personal income tax was equally imposed on all types of personal income. The income tax is assessed on the total income generated by each taxpayer within a year. At the beginning, it included two tax rates: the first tax bracket was subject to a rate of 25%, while the second bracket was paid at a rate of 35%. The limits of each tax bracket depended on the level of basic personal deduction. In 1997, the lower taxation rate was decreased from 25% to 20%, while the non-taxable portion of income went up, with further increases in 1999.

The tax base for the income tax is the total income realised in Croatia and abroad (for foreign taxpayers, income realised in Croatia). The tax is progressive, and the rates are 15%, 25%, 35% and 45%. The distribution of the revenues from the income tax are divided between the state, municipalities, townships and counties at fixed percentages, according to the Law on Financing Local and Regional Entities.

The **corporate income tax (or profit tax)** reform was carried out simultaneously with the introduction of the personal income tax reform. In the period 1990-94, resident entrepreneurs were paying corporate income tax at the rate of 35%, and non-residents at the rate of 17.5%. In 1994, this system was replaced by a single-rate profit tax system. Corporate income or profit tax rate was 25%. At the beginning of 1997, the discrepancy between the personal income tax and corporate income tax was settled when the corporate income tax rate was increased to 35%. The current profit tax rate is 20%.

¹⁴³ As of August 2007. Institute for Public Finances, <http://www.ijf.hr/eng/taxguide/8-07/tax-table.pdf>.

Croatia implemented **excises** in 1993, when excise tax on coffee was introduced. Excises are paid in the absolute amount according to the measure unit (for automobiles, according to the engine power). In 1994, excises were introduced on products which were taxed at high sales tax rates: oil derivatives, personal cars, tobacco and its products, alcohol and alcohol drinks, beer and beverages. In 1997, excises on planes and vessels were introduced. The share of excises in the total revenues (1994-98) ranged between 8.10% in 1994 and 17.25% in 1997.

In 2002, new taxes were introduced, and the specific excise taxes were changed. A tax on obligatory insurance premiums for cars was introduced, while excise taxes on alcoholic beverages were reduced by 40%. The personal income tax in 2002 was somewhat lower than in 2001. At the end of 2002 and in 2003, the Croatian tax system also saw amendments of some tax laws. For instance, in 2003, amendments were passed on the Law on Personal Income Tax, the Law on Profit Tax and the Law on Financing of Local and Regional Self Government Units, whereby new changes were introduced to the reallocation of the personal income tax, and the Law on Contributions for Obligatory Insurance.

2.3.2.2 The welfare system and funding

Compulsory social security contributions are a kind of direct tax that is used to finance the social security system, and accordingly, in a broader sense they form a part of the tax system. The contributions are the primary revenue used to finance expenditure for retirement, and health and employment insurance. The contributions are collected from the employee and from the employer, and they are the revenues of three extra-budgetary funds:

- The Croatian Pension Fund - contributions for Pillar I pension insurance
- The Croatian Health Fund - contributions for health insurance
- The Croatian Employment Fund – contributions for accident insurance.

For employees insured in Pillar I, the contribution is paid to The Croatian Pension Fund, and for those insured in Pillars I and II, the contribution is paid to The Croatian Pension Fund and to the private insurance fund. Contributions for the Pillar II pension insurance are paid to the private insurance funds selected by the employee.

In 2007, social contributions paid by the employees and the employers altogether are at a total rate of 37.2%. The contributions paid by the employee include the insurance for retirement under the first and second pillar (20% for the first pillar, or 15 % under the first and

5% under the second pillar), while the employer pays 15% for health insurance, 0.5% for accident insurance and 1.7% for employment. The total contribution of the employee is 20%, and that of employer 17.2%. The basis for compulsory social security contributions is the salary.

Croatia spends about 8% of its GDP annually on health care. About 84% of the health care spending comes from public sources and the rest from private sources. Within the public sector, the Croatian Health Insurance Institute (HZZO) accounts for 96% of the general government spending on health care. The HZZO also plays a key role on the supply side by setting health care delivery standards and negotiating the volumes and prices of health services with the providers.¹⁴⁴

2.3.3 Privatisation

The overall privatization process began in 1991. Based on the Law on Transformation of Socially-Owned Enterprises, the first phase of privatization involved the transformation of former "socially-owned" enterprises into joint-stock or limited liability companies with defined ownership structures. Following independence, ten large infrastructure and utilities companies came under direct state ownership as "public enterprises", while the remaining socially-owned enterprises were to be privatized in a two-stage process. These enterprises submitted requests for commercialization to the Croatian Privatization Fund and could request "autonomous transformation", i.e. propose their own privatization plans, until 30 June 1992. The first-stage privatization was organized by the Croatian Privatization Fund, seeking wide participation by the employees and the population at large by offering preferential rights for share subscription at a substantial discount, and payment by instalments. A total of about 3,000 enterprises began the process of "autonomous transformation".

In 1996, the parliament adopted the Privatisation Act, which has been amended twice since (in 1997 and in 2000). It defines that the Portfolio of the Republic of Croatia consists of shares and interests held by:

- The Croatian Privatization Fund
- The National Deposit Insurance and Bank Rehabilitation Agency
- The Croatian Pension Insurance Institute

¹⁴⁴ Dubravko Mihaljek, "Health care policy and reform in Croatia: how to see the forest for the trees," in *Croatian Accession to the European Union: the Challenges of Participation*, ed. Katarina Ott (Zagreb: Institute of Public Finance: Friedrich Ebert Stiftung, 2006), 277-319., <http://www.ijf.hr/eng/EU4/mihaljek.pdf>.

- The Croatian Health Insurance Institute
- Public companies and institutions and companies owned or founded by the Republic of Croatia.

From April 1991 to October 1995, some 2,200 socially-owned enterprises, i.e. 75 per cent of the initial number of enterprises subject to privatization, accounting for more than 30 per cent of employment, were fully or almost entirely privatized. A further 750 companies were privatized in this manner between October 1995 and May 1999. The shares in the enterprises not privatized during the first stage were subsequently transferred to the Croatian Pension Fund (one third) and the Croatian Privatization Fund (two thirds). Under the responsibility of the latter, shareholdings were reduced by various methods, including auctions at the Zagreb Stock Exchange, direct trade deals, tenders open to foreign investors, as well as the free distribution of shares to war veterans, widows and their families. Shares in some specific enterprises were earmarked to be sold against frozen foreign exchange deposits (FFED).

Croatian citizens participated actively in the privatization: some 600,000 small investors acquired shares in more than 2,500 enterprises. The government also encouraged the establishment of Privatization Investment Funds (PIFs). These were specialized funds collecting vouchers and coupons in exchange for shares in companies put up for mass privatization. Contrary to other investment funds, the PIFs were not allowed to exchange shares against frozen foreign exchange deposits.

The second phase of the privatization process was implemented through a mass voucher privatization, starting in 1998. This privatization was, in effect, a distribution of the shares not sold in the first phase of the privatization. Vouchers were distributed to individuals affected by hostilities, such as injured servicemen, war widows and their families, and other displaced persons and refugees. The shares to be represented by vouchers were held in the portfolio of the CPF; the shares held by the state pension funds were not included in the process. In total, more than 500 companies sold their shares through voucher privatization. The first round of vouchers was distributed in June 1998, and the process was concluded by September 1998. Voucher privatization had ensured the privatization of 50 to 60 per cent of the residual portfolio of the CPF, including shares in 30 to 50 top-quality companies reserved for strategic investors or public offerings, constituting the final step in the complete privatization of the residual portfolio. With the voucher privatization completed, the privatization process had virtually reached its end, except for the small residual CPF portfolio

and the large state-owned enterprises. Further information on the progress of the privatization in Croatia is provided in Table 2.12.

Table 2.12 Net proceeds from privatization, DM million, 1991-98

	1991	1992	1993	1994	1995	1996	1997	1998*	Total
Cash	4.2	86.6	123.4	208.3	177	269.4	154.7	170.7	1194.3
Bonds for Reconstruction**	-	48.3	28.1	41.9	1.4	0.5	0.8	0.1	121.1
Swaps with FFCDs	-	157.4	455.6	741.9	257.7	253.7	152.1	37.7	2056.1
Total	4.2	292.3	607.1	992.1	436.1	523.6	307.6	208.5	3371.5

*1 January -31 July 1998, Cash proceeds include also earnings from the sale of PLIVA's shares on the international market, which were transferred through the CPF account.

**High-yield bonds in hard currency issued by the Ministry of Finance, which can be swapped for shares at a 30 per cent discount.

The Law on the Transformation and Privatization of Socially Owned Enterprises was also applied to the agriculture. The former socially-owned farms which had not filed requests for "autonomous transformation" were transferred to the Croatian Privatization Fund. These farms were organized as joint-stock or limited liability companies and were managed by their respective management boards. Some 180 cooperative enterprises were foreseen for privatisation under the Law on Farm Cooperatives. In some cases, agricultural enterprises were divided into smaller independent units. All agricultural trading and processing enterprises were privatized. Croatia also intended to privatize the entire food procurement and processing system.

The sectors not covered under the Law on Privatization were privatized under other provisions. Shares in banks were sold by their founding institutions or, in the case of financially troubled banks, with the assistance of the Agency for Bank Rehabilitation. The Law on Sea Ports provided for the privatization of port services and the award of concessions; the actual port was regulated by the port administration. Medical services and other activities within hospitals and clinics, but not the property or infrastructure, could be privatized in accordance with the Statute of Conditions for the Lease of Medical Facilities for Primary Medical Care and Hospitals.

The Law on Privatization included a provision for the privatization of public enterprises, i.e. provided for a separate law for the following state-owned enterprises:

- Croatian Petroleum Company (INA) - law adopted in 2002
- Croatian Electricity Company (HEP) - law adopted in 2002
- Croatian Radio and Television Broadcasting (HRT)
- Croatian Railways (HŽ)
- Croatian Post and Telecommunications (HPT) - law adopted in 1999

- Croatian Highways and
- Croatian Forests.

For every enterprise, the individual law defines the share of the company to be privatized, i.e. offered to foreign and domestic investors. Investors are chosen on the basis of a public tender in a transparent and legally-based manner. Prior to the adoption of each law and the initiation of the process of privatization, the government selects a privatization consultant in an international tendering procedure. It was envisaged that CPF ownership over the companies would evaporate by 2001 and that the privatization of the large state-owned enterprises would be achieved by 2004¹⁴⁵. In 1999, a bill on the privatization and division of the Post and Telecommunication Company HPT was passed.

A considerable inflow of foreign capital started in 1998: the sale of the remaining 14% stake in Pliva (May 1998), an agreement on the acquisition of a 35% stake in Slavenska Banka by the EBRD and an Austrian bank, the DEM 50 million subscription by the EBRD of convertible preference shares of Podravka, and in September 1998 the award of a second mobile telephone license to VIP-net, to a consortium of Austrian, American and Croatian firms.¹⁴⁶ The privatisation of the Croatian Telecom Company (HT) followed.

Since June 2000, all state-owned companies are held by the State Privatisation Fund (HFP), which planned to sell the shares using different methods. Non-profitable enterprises were supposed to be sent into bankruptcy. In November 2002, the government approved an operational plan for the privatization of the state portfolio. According to the plan, the privatisation of the state portfolio was to be finalised by December 2005.

Companies with a majority share ownership or of strategic importance were supposed to be publicly tendered (the plan required five such tenders a month to complete the privatisation process by 2005). Companies with a minority share ownership were to be offered through the "over-the-counter market", either in Varaždin or in Zagreb (100 a month).

At the beginning of 2003, the Croatian Privatisation Fund board resigned, and the government adopted a proposal to dissolve the Privatisation Fund and to establish a new entity completing the privatisation. This slowed down the preparation of new projects, and the

¹⁴⁵ WTO accession documents.

¹⁴⁶ European Commission, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions in the Council Conclusions of 29 April 1997 Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania, SEC (1998) 1727. (Brussels, 1998). http://ec.europa.eu/enlargement/pdf/enlargement_process/accession_process/how_does_a_country_join_the_eu/ap/981019_sec_1727_en.pdf.

portfolio of the Privatisation Fund HFP in November 2003 comprised some 1,080 companies, of which state ownership was above 50% in 156 companies.

During 2004 and the first half of 2005, a total of 386 companies were privatised, of which 366 involved minority stakes in companies (less than 25% of equity capital), sold at public auctions at the Zagreb and Varaždin capital markets. The Croatian Privatisation Fund also executed a sale of 21 companies in which the combined government portfolio exceeded 50% plus one share of the company's equity capital. These sales were executed by means of public invitation for bids. The first public-private partnership was established with an estimated duration of five years.

The government has also considered changes in the institutional structures, such as amendments to the Privatisation Act, as well as other laws directly associated with that Act and with a view to introducing new models of privatisation (such as MBO, ESOP, PPP, settlement, etc.). This was supposed to help in cleaning up the remaining government portfolio until the end of 2007 (the shipbuilding industry excluded). However, these changes were not adopted, and corruption scandals have further slowed down the process.

The criticism of the privatization process is based on the grounds that the control of the major enterprises has ended up in the hands of those with HDZ connections, and because shares were issued free of charge to certain persons on the basis of their war background.¹⁴⁷

2.3.4 Business climate

2.3.4.1 Competitiveness indicators

Since 2001, Croatia is included in the **World Economic Forum surveys** of global competitiveness. In the "Global Competitiveness Report 2007-2008", which encompasses 131 countries, Croatia is at the 57th place, and it has drawn closer to some of the new members states of the European Union (EU) – Poland at the 51st place and Hungary at the 47th place. Romania and Bulgaria, the newest members of the EU, are both ranked lower than the 70th place. According to the Business Competitiveness Index, which measures the competitive ability of a company, Croatia is at the 60th place, while the new members of the EU are ranked

¹⁴⁷ European Commission, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions in the Council Conclusions of 29 April 1997 Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania, SEC (1998) 586. (Brussels, 1998). http://ec.europa.eu/enlargement/pdf/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/980330_sec_586_en.pdf.

between the 30th and the 50th place (the Czech Republic is 32nd, Slovenia is 35th, Slovakia is 44th and Hungary is 47th).

Taking into consideration the methodological changes and the inclusion of new countries in the rankings (Puerto Rico, Libya, Oman, Saudi Arabia, Syria, Uzbekistan, and Montenegro), an analysis of this year's rankings shows that Croatia has achieved a real improvement of two places in global competitiveness, while it has improved by one position in business competitiveness compared to last year. Of the 12 pillars of competitiveness, Croatia is ranked best in "Health and Primary Education" (44th place), "Higher Education and Training" (46th place), "Technological Readiness" (49th place), and "Innovation" (50th place). Croatia is ranked below average in macroeconomic stability, goods and financial market efficiency, market size, and business sophistication.

The Fraser's Institute economic freedom indicator measures the degree to which the policies and institutions of countries support economic freedom. The cornerstones of economic freedom are personal choice, voluntary exchange, freedom to compete, and the security of privately owned property. Forty-two data points are used to construct a summary index and to measure the degree of economic freedom in five broad areas: (1) the size of the government; (2) the legal structure and the security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) the regulation of credit, labour and business. The 2007 index includes a number of new components based on the World Bank's Doing Business ratings based on 130 countries (including 11 new ones).

Croatia has been included in the Doing Business survey since 1995, and its rating is improving (see Table 2.13). The most significant progress has been achieved in the area of access to sound money (from 2.5 in 1990, 3.4 in 2005, to 8.2 in 2005). According to the size of the government, Croatia's ranking improved from 2.6 in 1995 to 6.4 in 2005, while the regulation of credit, labour and business improved from 4.0 to 7.0. The most troublesome areas are the legal structure and the security of property rights and freedom to trade internationally. The rating in the legal structure and the security of property rights has deteriorated, which is the result of the lower rating of impartial courts, while progress in the freedom to trade internationally has been limited by the international capital market controls.

Table 2.13 Index of economic freedom, Croatia	1990	1995	2000	2001	2002	2003	2004	2005
Summary Ratings (Rank)		4.4 (109)	5.8 (84)	6.0 (80)	5.9 (84)	6.0 (84)	6.2 (75)	6.4 (82)
1. Size of Government		2.6	2.8	4.1	4.1	4.2	4.0	4.4
A. General government consumption spending		1.9 (33.4)	2.5 (31.7)	3.2 (29.3)	4.0 (26.5)	4.1 (26.0)	4.0 (26.3)	4.2 (25.6)
B. Transfers and subsidies		5.9 (15.5)	4.7 (20.1)	4.4 (20.9)	4.4 (20.9)	4.6 (20.4)	4.0 (22.6)	4.4 (21.2)
C. Government enterprises and investment		0.0	2.0	7.0 (21.6)	7.0 (21.6)	7.0 (21.6)	7.0 (21.6)	8.0 (21.6)
D. Top marginal tax rate			2.0	2.0	1.0	1.0	1.0	1.0
(i) Top marginal income tax rate			4.0 (35-53)	4.0 (35-53)	2.0 (45-63)	2.0 (45-63)	2.0 (45-63)	2.0 (45-63)
(ii) Top marginal income and payroll tax rates			0.0 (56-68)	0.0 (56-68)	0.0 (62-75)	0.0 (53-71)	0.0 (53-71)	0.0 (62-75)
2. Legal Structure and Security of Property Rights		5.9	6.6	5.2	5.1	5.0	5.4	5.6
A. Judicial independence				3.1	2.8	2.3	3.1	3.7
B. Impartial courts		5.8	6.1	2.8	3.0	3.0	3.4	4.0
C. Protection of property rights				3.3	3.0	3.2	3.7	5.0
D. Military interference		7.4	8.3	8.3	8.3	8.3	8.3	8.3
E. Integrity of the legal system			8.3	8.3	8.3	8.3	8.3	8.3
F. Legal enforcement of contracts								6.7
G. Regulatory restrictions on the sale of real property								3.4
3. Access to Sound Money	2.5	3.4	7.8	7.9	7.8	7.9	8.1	8.2
A. Money growth		0.0 (62.4)	8.3 (8.6)	8.2 (8.8)	7.3 (13.7)	6.9 (15.7)	7.9 (10.3)	8.6 (6.9)
B. Standard deviation of inflation		0.0 (573.3)	9.2 (2.1)	9.2 (2.0)	9.2 (2.1)	9.7 (0.7)	9.7 (0.7)	9.8 (0.4)
C. Inflation: most recent year	0.0 (500.0)	8.4 (8.0)	8.9 (5.3)	9.0 (4.8)	9.7 (1.7)	10.0 (0.1)	9.6 (2.1)	9.3 (3.3)
D. Freedom to own foreign currency	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
4. Freedom to Trade Internationally		6.0	6.2	6.5	6.4	6.6	6.7	6.5
A. Taxes on international trade		7.0	8.5	7.7	8.0	8.0	8.6	8.8
(i) Taxes as percentage of exports and imports		7.0 (4.6)	8.3 (2.6)	8.3 (2.5)	9.2 (1.1)	9.4 (0.9)	9.5 (0.7)	9.5 (0.7)
(ii) Mean tariff rate			8.7 (6.7)	7.6 (12.0)	7.6 (12.0)	7.6 (12.0)	9.2 (4.1)	9.5 (2.4)
(iii) Standard deviation of tariff rates				7.0 (7.4)	7.0 (7.4)	7.0 (7.4)	7.0 (7.4)	7.4 (6.6)

B. Regulatory trade barriers				7.2	6.6	7.0	6.4	5.5
C. Size of the trade sector		4.5	4.5	4.6	4.6	4.7	5.0	4.6
D. Black-market exchange rates	0.0	8.4	10.0	10.0	10.0	10.0	10.0	10.0
E. International capital market controls	0.0	2.0	0.0	0.8	2.9	3.4	3.8	3.9
5. Regulation of Credit, Labor and Business		4.0	5.5	6.1	6.2	6.3	6.6	7.0
A. Credit market regulations	0.0	3.4	7.7	9.1	8.9	9.0	9.3	9.2
(i) Ownership of banks	0.0	0.0	10.0	10.0	10.0	10.0	10.0	10.0
(ii) Foreign bank competition							10.0	10.0
(iii) Private sector credit		6.1	7.2	7.4	7.7	8.0	8.1	7.9
(iv) Interest rate controls/negative real int. rates		4.0	6.0	10.0	9.0	9.0	9.0	9.0
B. Labor market regulations				4.9	5.0	5.3	5.5	6.4
(i) Minimum wage							5.6	5.6
(ii) Hiring and firing regulations				3.4	3.8	4.2	4.7	5.1
(iii) Centralized collective bargaining				6.5	6.2	6.7	6.9	7.1
(iv) Mandated cost of hiring								4.8
(v) Mandated cost of worker dismissal								6.5
(vi) Conscription		3.0	3.0	5.0	5.0	5.0	5.0	5.0
C. Business regulations				4.3	4.6	4.6	5.1	5.3
(i) Price controls	0.0	2.0	4.0	4.0	4.0	4.0	3.0	3.0
(ii) Administrative requirements				1.9	2.0	2.0	2.4	3.2
(iii) Bureaucracy costs					7.0	7.3	9.4	5.7
(iv) Starting a business				5.5	4.7	4.5	4.9	8.2
(v) Extra payments/bribes				5.7	5.4	5.4	5.6	5.7
(vi) Licensing restrictions								4.1
(vii) Cost of tax compliance								7.4

Source: James Gwartney Robert Lawson, Russell S. Sobel and Peter T. Leeson, 2007 *Economic Freedom of the World: 2007 Annual Report*, p. 74. *Economic Freedom Network*, available from http://www.fraserinstitute.org/Commerce.Web/product_files/EFW2007BOOK2.pdf

2.3.4.2 World Bank Doing Business indicators

The table below addresses the taxes and mandatory contributions that a medium-size company must pay or withhold in a given year in Croatia, as well as the measures of administrative burden in paying taxes, according to the World Bank Doing Business Indicator.

Table 2.14 Paying taxes in Croatia

Tax or mandatory contribution	Payments (number)	Time (hours)	Statutory tax rate	Tax base	Total tax rate (% profit)
Value added tax (VAT)	12	40	22.0%	Value added	
Tax on company name	1		fixed fee (HRK 500)		0.02
Fuel tax	1		1 Kuna	per litre	0.46
Forrest contribution 0.1%	1		0.1%	Turnover (purchase cost)	1.24
Corporate income tax 20.0%	1	60	20%	Taxable profits	11.39
Social security	12	96	17.2%	Gross salaries	19.41
Totals	28	196			32.5

*The names of taxes have been standardized. For instance, income tax, profit tax, tax on the company's income are all named corporate income tax in this table. When there is more than one statutory tax rate, the one applicable to the taxpayer is reported. The hours for VAT include all the VAT and sales taxes applicable. The hours for Social Security include all the hours for labour taxes and mandatory contributions in general. Source: Doing Business¹⁴⁸

2.3.5 Trade liberalisation and trade policy

2.3.5.1 Trade policy development

The main characteristic of Croatia's trade policy since the early 1990s was liberalization, in spite of the war and the related risky environment. The liberalisation of trade in Croatia to date is a reflection of its membership in the WTO and the conclusion of free trade agreements (bilateral ones and with EFTA), and the intention to join the EU.

The institutional links between Croatia and the European Community were regulated up to 1992 by the same instruments that were regulated the links between the SFRY and the Community. Pursuant to the Cooperation Agreement, Croatia had preferential access to the

¹⁴⁸ *Doing Business 2008 Croatia: A Project Benchmarking the Regulatory Cost of Doing Business in 178 Economies*, (World Bank Group, 2007), 72, <http://www.doingbusiness.org/Documents/CountryProfiles/HRV.pdf>.

market of the European Community, and also a preferential position vis-à-vis other states in the region.

An internationally compatible market framework was established in 1995, with the enactment of the Company Law and the Law on Trade, for the most part adjusted in accordance with the principles of the GATT and resulting in the substantial liberalization of foreign trade. This law granted free entry into the foreign trade activity, introduced the same treatment of foreign companies and traders as for domestic ones, and the same legal status for foreign investors as domestic ones. The transfer and repatriation of capital was also granted.

Accession to the World Trade Organization was among the main priorities of the government in the second half of the 1990s. Croatia introduced a revised Customs Tariff in 1994, aligned with the relevant international conventions.¹⁴⁹ Some financial incentives and subsidies were provided to the agriculture in accordance with the Law on Financial Incentives and Subsidies in Agriculture and Fisheries (and its amendments). The government intended to maintain guaranteed prices for a small group of agricultural products, while the system of variable levies was abolished.¹⁵⁰ By the implementation of the new tariff regime in 1996 and the signature of agreements with neighbouring countries, the liberalisation of the trade policy continued. While foreigners were able to freely repatriate deposits, certain restrictions remained for Croatian citizens on foreign exchange deposits.¹⁵¹

Since joining the WTO in 2000, the Croatian efforts have been focused on the EU, and the Croatian trade policy is given shape within the context of the restrictions that are laid down by the membership in the WTO and in regional trade agreements, and by Croatia's expressed intention to join the EU.¹⁵² By joining the WTO, Croatia bound itself to gradually reduce its customs duties on industrial and agricultural products to the level that is applied in the OECD countries, by the year 2005. The export and quantitative restrictions and the measures that have a similar effect have been abolished.

¹⁴⁹ Croatia implemented the amendments to the International Convention on the Harmonized Commodity Description and the Recommendation of the World Customs Organization Regarding Ozone Layer Depleters and the Draft Recommendation on Drugs.

¹⁵⁰ Report of the Working Party on the accession of Croatia to the World Trade Organization, <http://www.wto.org/>.

¹⁵¹ European Commission, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions in the Council Conclusions of 29 April 1997 Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania, SEC (1998) 586. (Brussels, 1998). http://ec.europa.eu/enlargement/pdf/enlargement_process/accesion_process/how_does_a_country_join_the_eu/sap/980330_sec_586_en.pdf.

¹⁵² Ana-Maria Boromisa and Mia Mikić, "The European Union as determinant of Croatian trade policy," in *Croatian accession to the European Union: Economic and Legal Challenges*, ed. Katarina Ott (Zagreb: Institute for Public Finances : Friedrich Ebert Stiftung, 2003), 139-157., <http://www.ijf.hr/eng/EU/boromisa-mikic.pdf>.

By 2002, the use of administered prices in Croatia was limited to agricultural products, energy and transport. This level of price liberalisation, according to the criteria of the European Commission, was considered advanced, and it was comparable with most advanced applicant countries at the time.¹⁵³ Since then, the European Commission has not changed its estimate regarding price liberalisation. However, the rating of price controls that indicates the index of economic freedom deteriorated in 2004 (from 4.0 to 3.0).

Trade with the EU in the period 2002-05 was regulated by the Interim Agreement that enabled the application of the commercial provisions of the SAA until the process of ratification was completed. The Interim Agreement contractually regulated trade preferences somewhat more favourably than those that were applied to Croatia after the collapse of the SFRY, including also an agreement on trade in textile products between the Commission and Croatia, which has been in place since 1 January 2001, providing for the elimination of the quantitative restrictions on Croatian textile and clothing exports.

According to the Interim Agreement, Croatian industrial products, all processed agricultural products, apart from wine, baby-beef and beef products, have duty-free access to the EU market without any quantitative restrictions. Croatia bound itself to liberalise access to its market gradually, over a period of six years. Since 1 January 2002, about 77% of the trade in industrial products has been liberalised; trade in textile and steel products has been gradually liberalised by 1 January 2006, as was trade in all other industrial products by 1 January 2007.

With respect to agricultural products, 75% of the trade was liberalised by 1 January 2006, 41% by the abolition of customs duties and 34% by preferential treatment covering traditional trade. Following the expiry of the transitional period, trade in processed agricultural and fish products are totally liberalised¹⁵⁴.

The establishment of regional cooperation became a standard provision of the agreements between the EU and third countries. This form of cooperation was achieved by the applicants by the creation of CEFTA. Croatia's membership in CEFTA became effective in 2003. Following the EU enlargement in 2004, CEFTA became a free trade zone between Croatia, Bulgaria and Romania. In 2007, when Bulgaria and Romania joined EU, CEFTA lost its members.

¹⁵³ European Commission. *The Stabilisation and Association process for South East Europe - First Annual Report* [SEC(2002) 339] [SEC(2002) 340] [SEC(2002) 341] [SEC(2002) 342] [SEC(2002) 343]. (Brussels, 2002), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2002:0163:FIN:EN:PDF>.

¹⁵⁴ Ibid.

In the framework of the Stability Pact for South Eastern Europe, trade liberalisation and facilitation among South East European countries was initiated in 2001. Croatia has committed to joining the regional free trade zones in the Western Balkans based on the Stabilisation and Association Agreement. The liberalisation of trade in SEE has been seen as a tool to increase the volume of regional and international trade, to improve the capacity of the region to attract foreign direct investment, and to enhance the integration of the region into the European structures and the global economy.

The principles of the trade liberalisation in SEE were the conclusion of a network of bilateral free trade agreements by 2002 and liberalising at least 90% of the trade among the parties, within a transitional period of six years. Aligning the existing bilateral free trade agreements with these principles was the basis for their multilateralisation, as well as for the future liberalisation of services and the harmonisation of legislation, *inter alia*, in the fields of customs, phytosanitary, standards and conformity assessment, competition and intellectual property.

The explanation for the disappointing export performance does not seem to lie in a loss of price or cost competitiveness, but rather in the lack of reform in the labour and enterprise sector and the remaining administrative barriers to foreign investors. The export structure has been largely unchanged and thus reflects the continued domination of the former and the current public enterprises (in particular shipbuilding with large import components). Croatian trade is also restricted, since it is not yet integrated in the pan-European system of diagonal cumulation. Furthermore, regarding the exports to the EU, the Croatian companies are often not able to apply the EC standards.¹⁵⁵

2.3.5.2 Financial liberalisation

The first step of financial liberalisation was the introduction of the new currency, when the Croatian Dinar was replaced by the new currency, the Croatian Kuna in May 1994.¹⁵⁶ The introduction of the new currency marked the beginning of a new phase of the financial liberalisation and reform.

¹⁵⁵ The Western Balkans in Transition, *European Economy occasional papers*, no. 1 (2003), http://ec.europa.eu/economy_finance/publications/occasional_papers/2003/ocp1en.pdf

¹⁵⁶ The Centre for the Study of Global Governance, "The Croatian Banking System," *Discussion Paper*, no. 23 (2003), http://www.lse.ac.uk/Depts/global/Publications/DiscussionPapers/DP23_FinancialLiberalisationAndGlobalisation.pdf.

The aim of the stabilisation programme was not only to lower the inflation rate, but also to ensure economic growth. The integration of the financial market was planned as the second phase of the development strategy, discussed following the stabilisation programme, as it requires the coordination of monetary and exchange rate policies with partner countries. Financial liberalisation also implies an important role for the government and international regulatory institutions in setting the standards in the financial industry, and in carrying out the process of supervision.

Full current account convertibility was introduced in May 1995, followed by a bank rehabilitation programme in November and the introduction of capital adequacy standards in the December of the same year. The Bankruptcy Law was adopted in January 1997, which was replaced by a new one two years later. The Banking Law adopted in December 1998 was also changed by the adoption of a new Banking Law in July 2002.

The process of financial liberalisation in Croatia has had as a consequence a proliferation in new banks. There were 43 banks in 1993, 54 banks in 1995, and 61 banks in 1997. The number of banks has been falling since 1997, to 43 at the end of 2001 and to 35 in 2007. The share of state-owned banks in the total banking sector assets has declined substantially, from 78.5% in 1996 to 45.5% in 1999, to only 5.7% in 2000, and still declining to 4.2 % in 2006.

The process of the privatisation and the internationalisation of the Croatian banking system was almost completed during 2002. According to the European Bank for Reconstruction and Development, during 2002, the Croatian government sold its stake in Dubrovacka Banka, Unicredit/Allianz Group completed the takeover bid for Zagrebacka Banka, as the largest bank in Croatia in terms of assets, and the government sold its 25% stake in Splitska Banka. As a consequence of the privatisation deals, and the mergers and acquisitions in the Croatian banking sector during 2002, eight foreign banking groups now control over 90% of the total banking assets.

The aggregate balance sheet of the commercial banks has been characterised by the dominance of loans extended to enterprises and citizens. The share of these loans has increased from 43% in 1993 to 61% in 2007. Loans to enterprises have been constantly decreasing, from 38.8% in 1994 to 32.6% in 2000 and 27% in 2007, while the share of loans to households increased from 6% to 54% in the same period.

The substantial increase in deposits and assets in 2001 was primarily caused by the conversion of the former Western European currencies to the Euro. The share of money

assets and deposits with the Croatian National Bank increased from 10.4% in 1999 to 15% in 2001.

During the 1990s, Croatia made significant progress in developing its financial sector. The banks recovered from a state of near bankruptcy, money and capital markets were established, and a market-oriented legal framework was introduced. However, numerous banks experienced severe problems in 1998 and early 1999.

2.3.5.3 The bank system

Following the introduction of a market-oriented legal framework in the early 1990s, significant progress was made in establishing a modern banking system until 1997: the banking system recovered from the near bankruptcy state it had been in at the beginning of the transition and expanded vigorously until the end of 1997.¹⁵⁷

During the 1990s, the banking system was confronted with several inherited problems that had to be solved, among them the issue of households' foreign currency savings, which had been redeposited with the National Bank of Yugoslavia. When the latter seized all foreign exchange reserves after the dissolution of Yugoslavia, the Croatian government assumed responsibility for these bank claims. Since its foreign exchange reserves were not sufficient, the government issued German Mark-indexed bonds to the banks in late 1991 to prop up their assets as a countervalue of the foreign exchange deposits. At the same time, households' foreign exchange deposits were frozen by the government for a period of three years in order to ease the liquidity pressure on banks, to be gradually unfrozen at a minimum rate of 20 semi-annual instalments. By the end of 2004, these deposits had been paid back almost completely.

Owing to the very liberal bank licensing regulations with low minimum equity capital requirements and given the relatively liberal supervision framework, the number of banks grew substantially during the 1990s and reached 60 by 1997. Several new universal banks entered the market thanks to the relatively lax requirements, but they were too small to achieve an efficient scale. At the time, the incentives to improve the efficiency of the banks were limited, since deposits grew rapidly and banks could earn high returns by lending surplus funds to the ailing state banks. The opportunities for unsound bank behaviour were exacerbated by shortcomings in the prudential and legal framework and by a poorly designed

¹⁵⁷ This chapter is based on Thomas Reininger and Zoltan Walko, *The Croatian Banking System*, available at http://www.oenb.at/en/img/fsr_09_special_04_tcm16-29258.pdf.

deposit insurance scheme, which provided depositors with few incentives to monitor the banks' financial health.

The incentives for sound bank behaviour were not fully established, and public financial support was repeatedly granted to several state-owned banks in an attempt to restore their long-term viability. In 1995-96, a bank rehabilitation programme was implemented (at the cost of around 6% of the GDP), which helped solving the inherited problems (i.e. the issue of households' foreign currency savings which had been redeposited with the National Bank of Yugoslavia, the debt owed by the insolvent large state-owned enterprises, and the counterproductive cross-ownership structures institutionalized by the early indirect bank privatizations).

At the end of 1997, four state-owned banks (Slavonska banka, Riječka banka, Splitska banka and Privredna banka), which accounted for 32% of the total bank assets, were financially and operationally restructured under the 1994 Law on Bank Rehabilitation. While these procedures successfully broke the linkages between the weak state banks and the loss-making state enterprises, the privatization of the rehabilitated banks was initiated in 1998. Several banks were privatised in a way that left the old management in control and did not break their ties with the enterprises which used to own them. During the ensuing credit boom, banks' risk management was often weak, their credit processes were poorly controlled — related party lending and single-client exposure were common practices — loan loss provisioning was inadequate and the competition for deposits was often irresponsible. Bank failures began to occur when the loans were not repaid in time as the economic growth slowed down because of the tightened fiscal and monetary policies which were implemented in 1998 in response to a sharp deterioration in the external balances.

The difficulties were exacerbated by adverse external factors (e. g. the Asian financial crisis in 1997, the Russian crisis in 1998, and the Kosovo war) and peaked in a banking crisis in 1998-99. The crisis affected 16 banks; 12 of these banks exited the market, 2 were merged with other banks, and only 2 were rehabilitated. As a result of this consolidation process and several bank mergers, the number of banks declined from 60 by end-1998 to 43 by end-2000.

One major outcome of the crisis was the government's decision to sell the remaining state-owned banks to foreign strategic investors. In 1998, there were still no more than ten foreign-owned banks operating in Croatia, with a share of 6.7% in the total banking sector assets. The situation tipped in late 1999 and early 2000, when the government stepped up its privatization efforts, selling the country's second, third and fourth-largest banks (as measured

by their total assets) to foreign strategic investors, and placing the majority of the shares in the largest bank with foreign investors through the London Stock Exchange.

This step and the sale of smaller banks to foreign investors, as well as the establishment of new banks by foreigners led to an increase in the number of foreign-owned banks to 24; by 2001, they accounted for 89.3% of the total bank assets. By September 2004, their number was reduced to 17 as a result of several mergers, but their share in the total banking sector assets had increased to 91%. By the end of September 2004, 39 banks operated in Croatia, with privately owned banks accounting for approximately 97% of the total banking sector assets, and the share of the banks that were majority-owned by foreign investors amounting to 91% (one of the highest shares in the region). Italian and Austrian banks are among the largest foreign investors in the Croatian banking industry.

The banking sector concentration decreased between 1995 and 1997; however, the four largest banks (Zagrebacka Banka, Privredna Banka, Erste & Steiermarkische Bank, and Raiffeisenbank Austria) managed to strengthen their position again after the banking crisis of 1998-99. These banks accounted for 64.3% of the total assets by the end of September 2004, up from 53.1% at the end of 1997. As a result of this high concentration, the soundness of the largest systemic banks has an enormous impact on the overall stability of the banking system. However, the risks are mitigated by the foreign strategic ownership.

In December 1998, the new Banking Law entered into force aiming at increasing the National Bank's authority over the numerous small banks (60 banks and 33 saving associations) composing Croatia's banking sector.

The Herfindahl-Hirschman index of banking sector assets shows a decrease in concentration until 1997, thus substantiating the concentration ratios measured on the basis of the four largest banks' asset shares. The index figure increased between 1998 and 2000 as a result of the bank mergers, before falling back to 1,237 in 2002, rising again to 1,363 in 2004 and falling again to 1,270 by September 2007.

Table 2.15 Herfindahl-Hirschman index of the banking sector

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Q3/07
All banks	1,5967	1,267	1,016	1,018	1,190	1,368	1,316	1,237	1,270	1,363	1,358	1,297	1,270

Source: Croatian National Bank

The development of the interest rate margin (i.e. the difference between the interest rates on loans to enterprises and households and those on their deposits) also serves as an indicator of

the development of competition. Before the banking crisis of 1998-99, this margin was at a double digit level (except in 1997). It declined until the end of 2001, following a decrease in the interest rate level. Changes in the computation method from January 2002 led to a jump in the credit rate, and consequently, also in the interest rate margin. The 2003 rise in the interest rate margin probably reflects the tightening of the monetary policy during early 2003, which prompted banks to raise credit rates while maintaining low deposit rates.

At present, the minimum amount of authorised capital required to establish a bank is HRK 40 million. The shares of the bank must be registered and fully paid in cash prior to bank registration or before an increase in the authorised capital is registered. The shares must be released in a dematerialised form. Whether direct or indirect, the acquisitions of a bank's shares (by the same person) which ensure a certain capital interest or voting rights, are subject to prior approval by the CNB if the portion to be gained is 10% or more (a qualifying holding), 20% or more, 33% or more, 50% or more, or 75% or more. The minimum capital adequacy rate is 10%, although the Croatian National Bank may also set a higher rate if it finds that the bank's business contains risks. Bank operations must follow the principles of liquidity and solvency. Certain provisions have been adopted with the new Banks Act that will come into force on the day Croatia becomes a full member of the EU.

A foreign bank may provide banking and other financial services in the Republic of Croatia only through a branch licensed by the Croatian National Bank. A branch is not a legal entity. In the Republic of Croatia, the branch may conduct business operations with third persons within the authority given by the parent bank, with the latter being liable for all commitments arising in Croatia from the transactions carried out by the branch. In order to issue a licence, the CNB may make it a condition that the foreign bank deposit a certain amount of money or provide another security to make sure that its liabilities in the Republic of Croatia will be settled.

The Croatian financial sector is dominated by commercial banks, accounting for 77.6% of assets in mid-2006, which are to a large extent foreign-owned and generally very liquid, well capitalised, and highly profitable. Banking supervision lies within the responsibility of the Croatian National Bank and is in line with the EU best practice. One of the key challenges is to manage robust credit growth, while simultaneously fully liberalising the capital account. Another challenge is to implement a comprehensive overhaul of the regulatory framework for banking supervision and payment services. Third, the credit risk associated with the high level of Euroisation, as well as a generally weak legal framework for the enforcement of creditor rights, remain potential vulnerabilities to the banking system.

In the non-banking sector, the key challenge will be the development of the securities market in order to sustain the growth of domestic institutional investors¹⁵⁸ (pension and investment funds, insurance companies).

2.3.5.4 Capital movements and regulation

Current payments, direct investment abroad and long-term credit transactions have been liberalised in Croatia. The amendments to the Foreign Exchange Act in 2003 liberalised the use of foreign currency, and the latest amendments (in 2006) enabled the full liberalisation of portfolio investment. However, there is still a differentiation between investment into domestic and foreign assets.

Croatia prohibits the granting of financial loans with a maturity of less than one year to non-residents. Furthermore, resident physical persons investing in foreign securities are obliged to execute their investments via domestic brokerage houses and deposit the purchased securities in a domestic custodian bank.

The opening of accounts abroad by residents is generally prohibited. Cash withdrawals and deposits from bank accounts held by non-resident legal persons are restricted, though a recent CNB decision, still to enter in force, limits these restrictions to deposits in the local currency. There are restrictions on cash transactions between residents and non-residents, while cash payments on the basis of capital transfers are prohibited. Limits also exist to personal transfers abroad of assets related to gifts and grants, of the export of foreign cash by residents and of the export and import of domestic cash by both residents and non-residents. The statistical reporting to the CNB of the credit transfers is a prerequisite for the execution. Also, the Income Tax Act and related regulations provide that the payments of receipts that are deemed income have generally to be made to taxpayers' accounts (cash payments being prohibited). The report identifies the following restrictions:

- The Insurance Act provides that until the EU membership, residents may insure property and persons only with domestic institutions.
- There are restrictions on the activities of foreign or foreign-owned legal persons in some sectors, namely in air carriers, and in seawater as well as in freshwater fisheries.

¹⁵⁸ European Commission Directorate-General for Economic and Financial Affairs, *2006 Pre-accession Economic Programmes of candidate countries*, European Economy, no. 31 (2007), http://ec.europa.eu/economy_finance/publications/occasional_papers/2007/ocp31en.pdf.

- The assets in a building saving's account of a Croatian citizen can be used only in Croatia.
- Banks are obliged to ensure at the end of each workday that their total open foreign exchange position, increased by their position in gold, does not exceed 20% of their regulatory capital.

Special government rights (“golden shares” with veto rights) are foreseen in the privatisation acts of the telecom (Hrvatske telekomunikacije-HT), electricity (Hrvatska elektroprivreda-HEP), and oil (Industrija nafte – INA) companies. Croatia has not provided a timetable for the abolition of these special rights.

A 10% limit on individual or joint shareholding in HEP is included in the respective Privatisation Act, as well as for the Central Depository Agency pursuant to the Securities' Market Act. In both cases, the state is not restricted by this ceiling. There are a number of restrictions on the foreign ownership of real estate:

- The acquisition of real estate by a national of a foreign country is subject to the requirement of reciprocity and, except when acquisition is by inheritance, an administrative authorisation by the Minister of Foreign Affairs and European Integration after securing the opinion of the Minister for Justice. The Minister's decision is subject to judicial review before the Administrative Court pursuant to the Act on Administrative Lawsuits.
- The acquisition of agricultural land, forests and forestland in private ownership is prohibited for foreign legal and natural persons, unless otherwise provided by international agreements. The acquisition of proprietary rights over natural resources (strict reserves, national parks, special reserves, nature parks, regional parks, significant landscape, forest parks and park architecture monuments) and excluded areas for security reasons is also prohibited.
- The Croatian legislation provides that certain categories of real estate, in particular, state-owned forests, state-owned forest land and the public water domain, are unalienable from state ownership and may therefore not be acquired either by Croatian citizens or by aliens. Similarly, certain categories of real estate (the maritime domain, seaports, and public roads) are excluded from legal transactions (public goods), of which neither Croatian nationals nor aliens may acquire ownership nor other proprietary rights. The state and local self-government units have pre-emption rights on real estate in protected areas and on cultural goods.

2.3.5.5 The Stock Exchange

The Zagreb Stock Exchange or ZSE (Zagrebačka burza) was established in 1991 by 25 banks and 2 insurance companies. In 1994, the system of electronic trade was introduced. In the first five years of electronic trade (1995-2000), market capitalisation increased by almost 10 times (982.6%). Despite the significant improvement in relative terms, in absolute values the development of capital markets was rather limited, with a number of companies taken over by foreign investors, which further reduced the number of the listed companies. However, the authorities established rules for the obligatory listing of companies even though their shares might not be traded.

The reform of the pension system in 2002 and the investment needs of the pension funds promoted capital market development. A foreign exchange law, adopted in June 2003, further liberalised the use of foreign currencies.¹⁵⁹

In March 2007, the ZSE was merged with the other Croatian stock exchange, the Varaždin Stock Exchange¹⁶⁰, to form a unique Croatian capital market, the largest one in the region. As of November 23 2007, the ZSE included the stocks of 383 companies, with a market capitalization of 369.6 billion Kuna (EUR 50.4 billion). The Zagreb Stock Exchange publishes two indices: CROBEX (stocks) and CROBIS, (bonds).

¹⁵⁹ “The Western Balkans in Transition.” *European Economy occasional papers*, no. 5, (January, 2004), http://ec.europa.eu/economy_finance/publications/occasional_papers/2004/ocp5en.pdf.

¹⁶⁰ The Varazdin Stock Exchange was founded in 1993. Trading was held through the order-driven trading system. According to the January 2007 issue of *Investitor*, its market capitalization at the beginning of 2007 amounted to EUR 9.8 billion.

Figure 2.22 The development of the CROBEX index, 2003-08

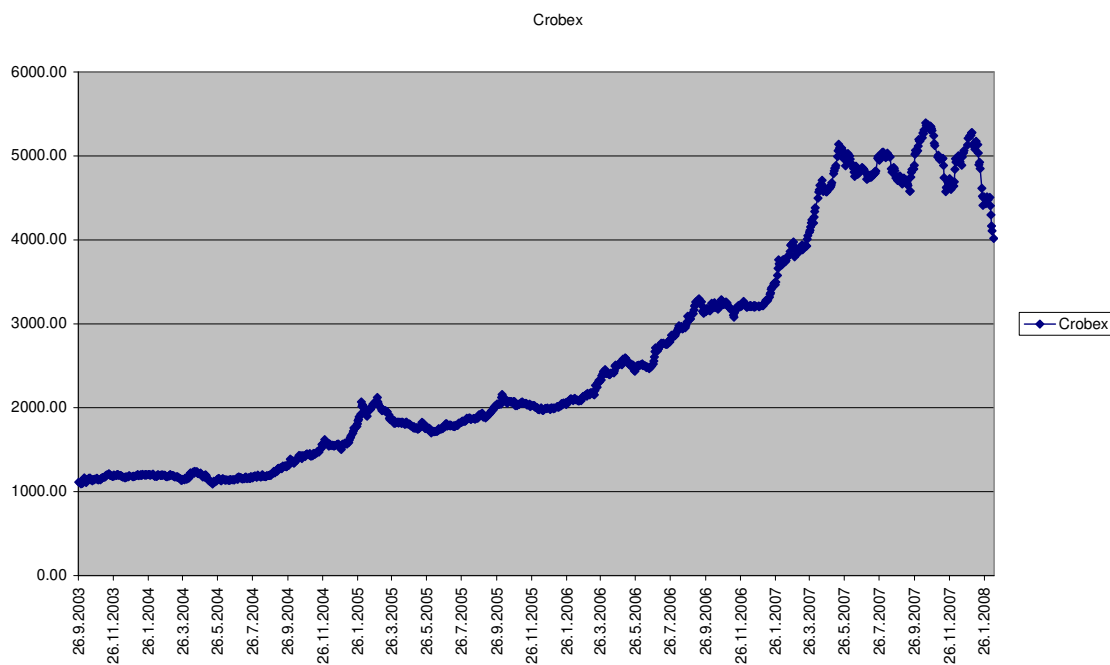
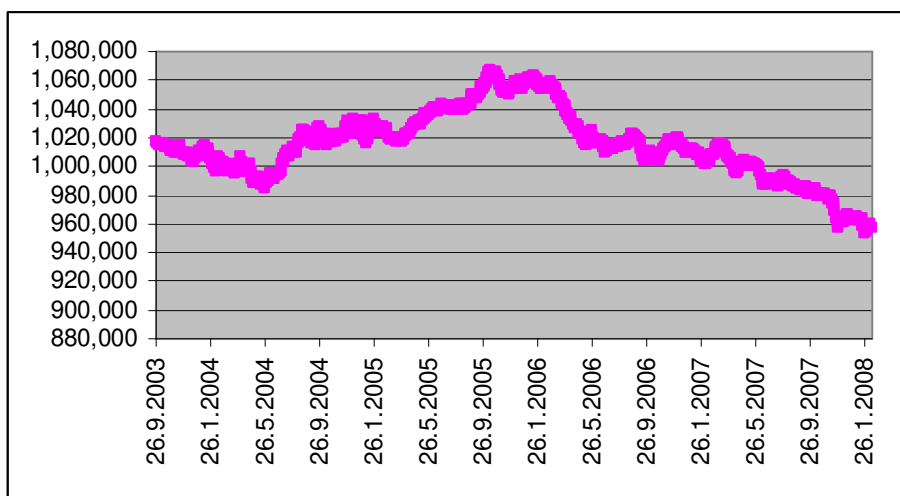


Figure 2.23 The development of the CROBIS index, 2003-08



2.3.5.6 The informal economy

The different estimation methods of the unofficial economy give different results. The national accounting discrepancy method shows a growth of the unofficial economy from 1990 to 1993 to a maximum of 37% of the GDP and then a constant fall to 7% in 2000. In the 1990-95 period, the unofficial economy came on average to about 25%, and in 1996-2000 on

average to about 10% of the GDP. The Eurostat method and the estimates of the tax evasion coincide with these trends, while the two monetary methods and the electricity consumption method show a rise in the unofficial economy in the 1995-99 period, ranging between annual levels of 22% and 34%, followed by a fall in 2000. Because of uneven results obtained with different methods and because of the uncertainty whether this is a real reduction in the informal economy or just an improvement in the statistics, the analysis of the unofficial economy shows that it decreased in the period 1990-2000.¹⁶¹

Table 2.16 Employment in the unofficial economy, 1991-96, %

	1991	1992	1993	1994	1995	1996
Calculation based on the relation between the assumed and registered population activity rates	0.0	6.42	16.79	19.03	17.50	15.53
The Survey on Employment results					25.8	

Source: Bićanić, Ott. The Unofficial Economy In Croatia, Causes, Size and Consequences, Occasional Paper No 3. November 1997. p.30

In the second half of the 1990s, the estimated size of the informal economy was 16-21% of the official GDP. The sectors with informal economic activities of some significance were trading, catering, construction, domestic appliance and car repair, commercial and residential property rental, business services and household personal services, while the processing industry and agriculture appeared to be less affected. Steps taken to constrain the informal sector included the development of an effective tax system (in particular, the VAT), lower taxes and improved labour relations within a stronger regulatory framework, and more effective labour inspection.¹⁶²

A recent survey¹⁶³ estimated the share of the grey economy on the basis of the share of illegal income, i.e. the share of income for which social security contribution and taxes are avoided. The estimates range from 0-50%, while on average employers and employees estimate that roughly 1/3 of the salary is paid illegally. The most affected sectors are trade (distributive trade), construction, and the tourism and hotel industry. According to the survey,

¹⁶¹ Katarina Ott, "Neslužbeno gospodarstvo u Republici Hrvatskoj 1990-2000," in *Financijska teorija i praksa*, 1-30. (Zagreb: Institut za javne financije, 2002), <http://www.ijf.hr/FTP/2002/1/ott.pdf>.

¹⁶² Report of the working party on the accession of Croatia to the world trade organization, (2000) <http://www.wto.org/>.

¹⁶³ Nenad Bakić and Vesna Pliško, *Istraživanje o radu na crno Selectio grupe s Hrvatskom udrugom poslodavaca* (Zagreb, 2006), <http://www.moj-posao.net/download/istrazivanja/RadNaCrno.pdf>.

the most pronounced type of the grey economy is overtime work, payment in cash of a part of the salary, and housing and offices rental. According to the government's estimates, the grey economy in 2005 was 5.8% of the GDP per capita in PPP.¹⁶⁴

2.3.6 Infrastructure

2.3.6.1 Transport infrastructure

Some of the key European international land routes and railway links – including the historic Europe to Asia route – pass through Croatia. Numerous passenger and cargo ports are located along the coast, which is also home to nine international airports, four of which are located on the coast – Pula, Zadar, Split and Dubrovnik. Three are on islands – Krk near Rijeka and the islands of Lošinj and Brač – and two are in the central plain (Zagreb and Osijek). There are plans for new airports to be built on other islands.

The country also has six international seaports – Pula, Rijeka, Zadar, Split, Ploče and Dubrovnik – and dozens of small ports of local and regional importance. However, there are some problems with the sea connections between the islands, as well as with fast transfers between Central/East European and West European countries.

The Croatian Railways have very low cargo and passenger traffic and need modernisation. There are 48 lines in operation per 1000 km², which is comparable to the EU-25 (50 km of railway lines per 1000 km²).

When it comes to the share of tracks electrified, Croatia is below the EU-25 average, with 36% of the lines electrified (compared to approximately 50% in the EU-25). Also, in the period 1990-2003, the number of locomotives and railcars decreased by 30% (in the EU-25 by 21%) and the number of goods transport wagons decreased by 42%.

Table 2.17 The evolution of selected main networks in Croatia, 1990-2003, km

	1990	2000	2001	2002	2003
Railways	-	2 726	2 726	2 726	2 726
Motorways	291	411	429	455	554
Oil pipelines	-	601	601	601	-

Source: Panorama of Transport, Eurostat, 2007, p.9

¹⁶⁴ The Croatian and the EU statistics are not fully comparable. Croatia does not adjust the GDP figures for the effects of the grey economy. However, the Strategic Development Framework states that the adjustments of the GDP to include the grey economy would bring the Croatian GDP per capita expressed in PPP approximately to 52% of the EU average in 2005, compared to the 48% according to the Eurostat statistics.

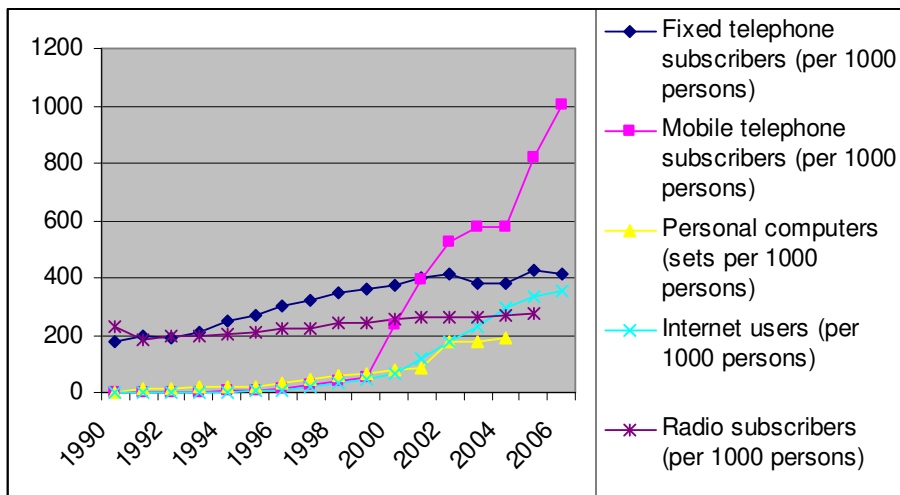
Motorway density (12 km/100,000 inhabitants for 2003) was at the level of the EU-25 (13 km /100,000 inhabitants). Construction continued in the period 2004-07, and the length of the motorways reached 900 kilometres in 2006.

2.3.6.2 Information and telecommunication technology

Compared to the other countries in Southeast Europe, the Croatian information and telecommunications sector is very well developed.¹⁶⁵ The South East Europe Core Regional Network Development Plan includes the improvement of the telecommunication network: planned is a project of covering the rail network and its interconnections with neighbouring states by an optical telecommunication network.

The indicators show that the fixed line penetration rate (32%) is relatively low compared to the EU average (45%), but it is higher than the average in the Southeast European countries (26%). Mobile line penetration is 103%, which is higher than the EU average.

Figure 2.24 Information and telecommunication technology indicators



Data source: WIIW

¹⁶⁵ Cullen International. *Report 4 – Country Comparative Report: Supply of services in monitoring of South East Europe – telecommunications* (2007), http://ec.europa.eu/information_society/activities/internationalrel/docs/eu_enlargement/cullen_report4_comparative_final_nov_2007.pdf.

2.3.7 Energy

The energy infrastructure in Croatia consists of the electricity network, the gas network and the oil pipeline network (JANAF). The electricity generation capacity consists of the power plants owned by the Croatian Power Supply Company (the HEP group), a certain number of industrial power plants, and a few privately owned power plants (wind power plants and small hydro power plants). HEP's total generation capacity in Croatia is 3,645 MW (including Thermal power plant Plomin Ltd, which is jointly owned by HEP d.d. and RWE Power, and excluding Nuclear power plant Krško, jointly owned by HEP d.d. and ELES GEN d.o.o.). The total installed capacity of industrial and other plants amounts to about 220 MW. The transmission network consists of approx. 720 km lines, 100 substations, 200 transformers, and the power of transformation is 11 MVA (see Table 2.18) The distribution network consists of 13,000 km lines and 2,500 substations (see Table 2.19).

Table 2.18 HEP Transmission network capacities in the Republic of Croatia

Voltage level	400kV	220kV	110kV	Medium voltage
Length of lines (km)	1 159	1 233	4 781	58
Number of substations	5	6	101	-
Number of transformers	5 (400/220 kV) 7 (400/110 kV)	16	158	*
Power of transformers (MVA)	2 000 (400/220 kV) 2 100 (300/110 kV)	2 270	6 472	-

Source: Energy in Croatia, 2005, p. 156

Natural gas is produced from 20 on-shore gas fields and 2 off-shore fields, which covers about 78.5 per cent of the total demand. The largest quantities come from Molve and Kalinovac, where the central gas stations for gas processing and transport preparation, Molve I, II and III, have been built. Their capacities are shown in Table 2.20.

Table 2.19 Distribution network capacities in Croatia

Voltage level	110 kV	35 (30) kV	20 kV	10 kV	0.4 kV	Household connections
Length of lines	85	4 594	3 890	29 836	61 645	28 363
Number of substations	51(110/35(30) kV) 30 (110/10 (20) kV/9	352 (35(30/10(20) kV)	2 806 (20/0.4 kV)	21 568 (10/0.4 kV)	-	-

The underground gas storage Okoli was designed with the nominal capacity of 550 million m³. The maximum injection capacity is 3.8 million m³/day, while the maximum withdrawal capacity is 5 million m³/day.

Table 2.20 Central gas stations' capacities

Central gas station	Installed capacity (10 ⁶ m ³ /day)
Molve I	1
Molve II	3
Molve II	5
Total	9

Source: *Energy in Croatia, 2005, p.138*

The natural gas transportation system comprises 1,657 km, with diameters ranging from DN 80 to DN 700. The system was designed for a work pressure of 50 bar and partly for 75 bar. During peak demand approximately 510,000 m³ per hour are transported, while a maximum quantity of 620,000 m³ per hour has been delivered to customers. The total theoretical capacity of the transportation system is 2,000,000 m³ per hour. The system includes 142 metering and reduction stations, with 210 metering points.

Figure 2.25 Gas network



Source: *Plinacro web pages, <http://www.plinacro.hr/transport.asp>*

There are 36 natural gas distribution companies in the Republic of Croatia, and the total gas pipeline length amounts to 15,980 kilometres. Additionally, there exist two distribution companies for city gas and LPG/air mixture distribution, with the total network length amounting to 239 kilometres. Thus, the total distribution network in Croatia is 16,219 kilometres long. The length of the distribution pipeline has more than doubled since 1995 (Table 2.21).

Table 2.21 Distribution pipeline in Croatia

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Length (km)	7 190	8 980	10 850	12 220	13 340	14 366	14 366	14 515	14 984	15 531	16 219

The oil pipeline network JANAF was constructed in 1979 as an international oil transportation system from the tanker and terminal port of Omišalj to domestic and foreign refineries in Central Europe. The designed pipeline capacity amounts to 34 million tons a year, while the installed one is 20 million tons. The total storage capacity at the Omišalj, Sisak and Virje terminals equals 900 000 m³ for oil and 60 000 m³ for oil products.¹⁶⁶

2.4 Tourism

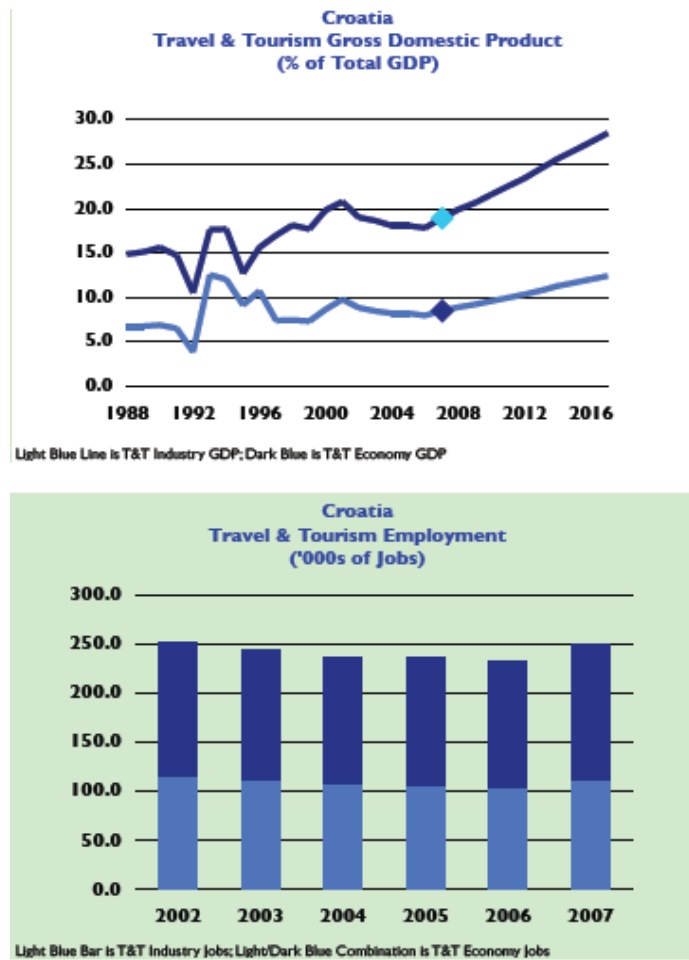
Croatia boasts a long tradition in tourism, and its economy is highly travel and tourism intensive. Croatia has five UNESCO World Heritage sites, eight national parks, and its main attraction is the Adriatic coastline.

Travel and tourism directly contributes roughly to 9.7% of the total employment and 8.5% of the total GDP. If the indirect effects are also considered, tourism and travel contribute to 19% of Croatia's GDP and 22% of the total employment.¹⁶⁷ The World Travel and Tourism Council estimates that in the period 2008-18, Croatia will continue to record above average growth levels (7.9 % annually).

¹⁶⁶ Ministry of Economy, *Energy in Croatia* (Zagreb, 2005), 113.

¹⁶⁷ World Travel & Tourism Council, *CROATIA 2007: The Travel and Tourism Economic Research*, http://www.wttc.travel/bin/pdf/original_pdf_file/1croatia.pdf.

Figure 2.26 Travel and tourism GDP and employment, 1988-2016



Source. *The Travel and Tourism Economic Research, Croatia 2007*.

The war in 1990 placed a great financial strain on the Croatian tourism industry, resulting in the near collapse of the travel and tourism demand and a significant gap between Croatia and its competing destinations (Spain, Italy, Turkey, Greece)¹⁶⁸ in terms of infrastructure and product development.

The events of September 11, 2001, uncertainty in the Middle East, and a slow economic recovery have led to increased price sensitivity among many of Europe's key source markets, such as Germany. As the majority of Croatia's tourists come from Germany (close to 18% of the total arrivals) this is of significant importance for Croatia's tourism. In addition to Germany, which has maintained its position as the international market leader since the late 1980s, the major sources are Croatia (i.e. the domestic market), Italy, Slovenia, the Czech Republic, and Austria. The former domestic Yugoslav markets that used to be

¹⁶⁸ THR International Tourism Consultancy, Barcelona, 2001.

important sources of tourism – Bosnia and Herzegovina, Serbia and Montenegro – shrunk significantly in size as a result of the war.

The rapid re-emergence of tourism¹⁶⁹ and the government's policy (e.g. as outlined by the Croatian Tourism Strategy 2010¹⁷⁰), aiming at targeting higher income groups, as well as the progressive reduction of the government's direct involvement in the industry provides opportunities to invest in a dynamic and growing sector. The investments and development of a comprehensive Croatian tourism offer should help extending the current tourist season, which is characterised by a high seasonality of demand. The three months from June through August account for 88% of the total overnight volume and 78% of the arrivals. The winter months (October to March) account for 5% of the nights and 11% of the arrivals.

Due to the importance of tourism for the economy, an individual Ministry of Tourism was established in 2008, aimed at mainstreaming policies for employment, trade, investment, education and environmental protection.

2.5 Macroeconomic forecasts

The starting point of the economic policy document, the Strategic Development Framework (SDF), is that government driven growth is not sustainable in the long run. Required is the strengthening of the private sector, its competitiveness and its overall ability to become the main driver of future economic growth. The key areas that can challenge growth and competitiveness relate to the completion of the transition process (mainly related to the reform of the judiciary and the public service), the development infrastructure (education, and an efficient labour market), and developmental links (macroeconomic environment, efficient and integrated financial services, natural resources, and regional development).

The Pre-Accession Economic program schedules measures for the achievement of the goals defined by the SDF. It can hence serve for the identification of the concrete challenges that should be tackled within three years. These include privatization (primarily by the means of capital markets), the elimination of administrative barriers for business development,

¹⁶⁹ There was a 6 per cent increase in total tourist arrivals in 2002, following a 19 per cent growth in 2001. International business was stronger in terms of growth than the domestic market with several markets, including the UK, recording a second year of double-digit growth. This means that arrivals ended in 2002 at 86 per cent of Croatia's 1989 peak.

¹⁷⁰ Ministry of tourism, *Croatian Tourism Strategy until 2010* (2003), <http://www.mint.hr/UserDocsImages/Strategija%20hrvatskog%20turizma%20-%20finalna%20verzija.pdf>.

labour market reform, the reform of the education system, and the reform of social welfare and related social benefits.

The key fiscal policy objectives in the period between 2007 and 2009 include the reduction of the budget deficit below 3% of the GDP, stabilisation and the further reduction of the public debt to less than 60% of the GDP, the decrease of foreign debt to values around 80% of the GDP, and support to a decisive implementation of the structural reforms.

Table 2.22 Macroeconomic forecast until 2013

	1994-97	1998-2001	2002-05	2006-09	2010-13
Rate of growth of the GDP in %	6.4	2.1	4.4	5.1	7.3
Inflation rate (year end, in %)	2	5	2.6	2.5	2
Unemployment rate (ILO methodology, in %)	-	14.9	13.9	12	9.5
Fiscal deficit /GDP, in %	-1.1	-5.5	-6.7	-6.5	-6.5
General government expenditures/GDP in %	48	52	50	48	45
Current account balance /GDP	-5	-5	-6.7	-6.5	-6.5
FDI/GDP, in %	1.7	6	5.1	7	6
Foreign debt/exports, in %	63.9	120.3	153.3	165.5	160
Export of goods and service /GDP, in %	41.8	44	50	54	58
Growth in EU-15, in %	2.3	2.9	1.5	2	2

Source: *Strategic coherence framework 2007 – 2013*, p. 36¹⁷¹

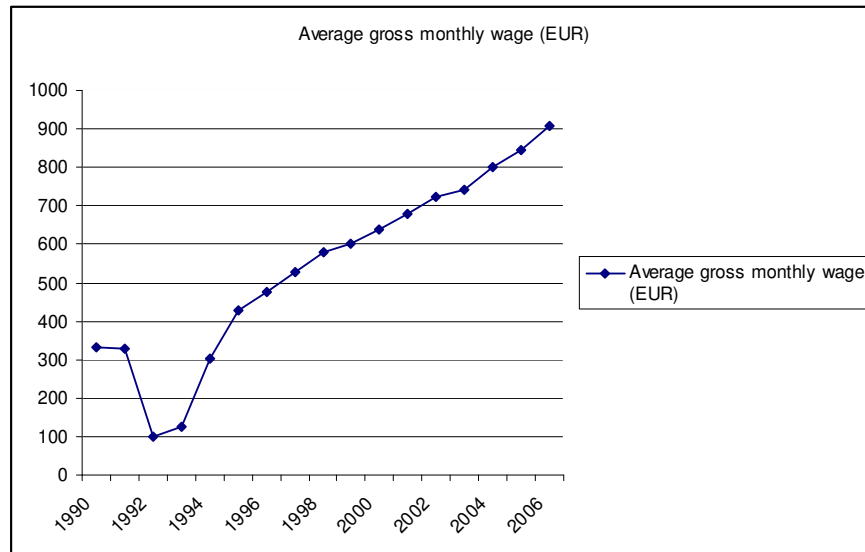
2.6 Welfare and financial services

2.6.1 Wages and incomes

Following the sharp decline in gross salaries in the period 1990-93, the average gross monthly wages have constantly grown since. The average salary has increased 7 times in the period 1993 2006, from EUR 127 to EUR 906 in 2006.

¹⁷¹ Central Office for Development Strategy and Coordination of EU funds, *Strategic Coherence Framework 2007-2013: Instrument for pre-accession assistance* (Zagreb: Central Office for Development Strategy and Coordination of EU funds, 2006), 36.

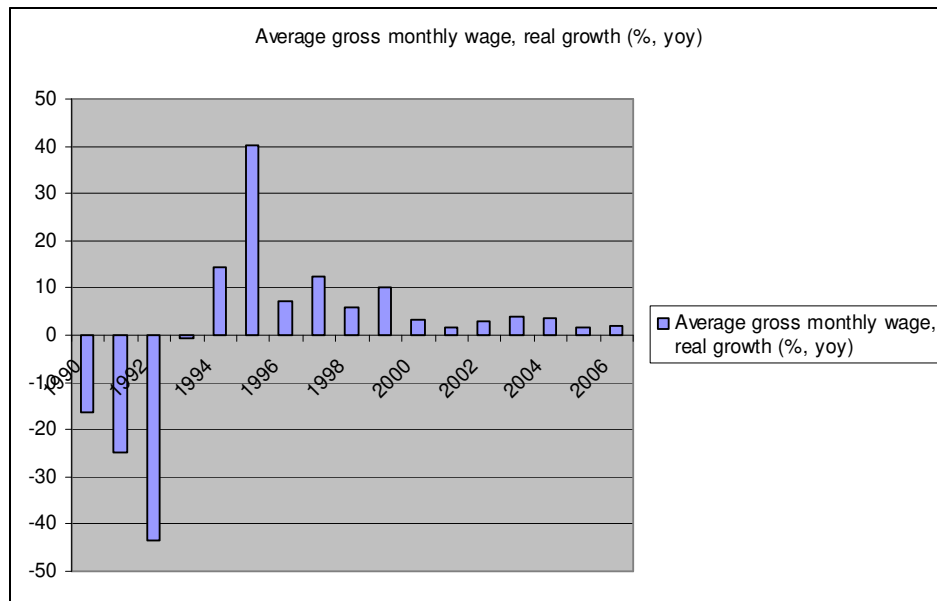
Figure 2.27 Development of wages



Data source: WIIW

However, the growth rates have varied considerably, between 14.45 in 1994 (yoy), 40.2% in 1995, and since 2000 they have been moderate, ranging from 1.5-3.4% (2.7% on average).

Figure 2.28 Average gross monthly wage, real growth, %, yoy



The highest average monthly earnings are in the service sector, followed by the industry, while the average gross earnings in the agriculture are 88% of the total average (in 2006, Table 2.23). Net monthly earnings range between 65-85% of gross earnings.

Table 2.23 Average gross monthly earnings by sector, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Total	4 131	4 551	4 896	5 366	5 236	5 985	6 248	6 634
Agriculture	3 558	3 005	2 909	4 383	4 477	4 795	5 039	5 640
Industry	3 681	3 869	4 100	4 864	5 130	5 400	5 645	6 064
Services				5 757	5 999	6 347	6 610	6 965

Source: DZS

Table 2.24 Average net monthly earnings by sector, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Total	2 681	2 999	3 326	3 720	3 940	2 173	4 376	4 603
Agriculture	2 409	2 726	3 065	3 720	3 287	3 504	3 698	4 088
Industry	2 421	2 614	2 855	3 409	3 635	3 801	3 995	4 245
Services				3 955	4 170	4 400	4 601	4 806

Source: DZS

In the industry, the highest wages are in mining and quarrying. Electricity and water supply and construction follow, while earnings are lowest in manufacturing (see Table 2.25).

Table 2.25 Average gross monthly wages in the industry, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Mining and quarrying	4 531	4 615	5 089	5 942	6 332	6 629	7 283	7 894
Manufacturing	3 681	3 869	4 100	4 794	5 043	5 288	5 575	6 003
Electricity, gas and water supply	4 729	5 113	5 382	5 700	6 086	6 720	6 913	7 342
Construction	3 473	3 630	3 663	4 549	4 884	5 105	5 212	5 593

Source: DZS

Table 2.26 Average net monthly wages in the industry, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Mining and quarrying	2 883	3 113	3 575	4 103	4 358	4 534	4 973	5 309
Manufacturing	2 421	2 614	2 855	3 346	3 561	3 711	3 934	4 189
Electricity, gas and water supply	3 103	3 530	3 754	4 047	4 358	4 750	4 916	5 179
Construction	2 318	2 420	2 597	3 232	3 501	3 636	3 733	4 806

Source: DZS

Since 1998, gross wages have increased between 1.4 (in public administration and defence) to 2 times (trade). Net wages increased more: between 1.6 (public administration, defence, health and social work) and 2.1 (trade and construction). The highest wages are in financial intermediation and the lowest ones in hotels and restaurants.

Table 2.27 Average gross monthly wages in the services, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Trade	3 558	4 551	3 875	4 616	4 877	6 347	6 610	6 965
Hotels and restaurants	3 453	3 610	3 859	4 406	4 739	5 204	5 406	5 701
Transport, storage and communication	4 324	4 908	5 461	6 300	6 718	7 100	7 585	7 948
Financial intermediation	6 413	6 998	7 634	8 853	8 858	9 153	9 801	10 376
Real estate	4 643	5 093	5 290	5 634	5 958	6 484	6 898	7 464
Public administration and defence	5 053	6 185	6 409	6 073	6 422	6 487	6 635	7 008
Education	4 046	4 624	5 093	5 381	5 650	6 030	6 153	6 428
Health and social work	4 989	5 789	6 358	6 407	6 613	6 954	7 404	7 765
Other services	4 662	4 994	5 153	5 583	5 926	6 530	6 673	7 125

Source: DZS

Table 2.28 Average net monthly wages in the services, HRK, 1998-2006

	1998	1999	2000	2002	2003	2004	2005	2006
Trade	2 334	2 441	2 692	3 205	3 424	4 400	4 601	4 806
Hotels and restaurants	2 306	2 432	2 706	3 126	3 377	3 617	3 785	3 962
Transport, storage and communication	2 825	3 204	3 704	4 345	4 678	4 906	5 250	5 464
Financial intermediation	3 900	4 468	4 892	5 697	5 843	5 993	6 417	6 725
Real estate	2 908	3 016	3 541	3 812	4 069	4 355	4 640	4 975
Public administration and defence	3 188	4 048	4 214	4 182	4 472	4 611	4 749	4 964
Education	2 646	3 256	3 491	3 771	4 005	4 224	4 342	4 510
Health and social work	3 144	3 874	4 220	4 364	4 005	4 781	5 109	5 136
Other services	2 960	3 187	3 495	3 861	4 144	4 493	4 634	4 906

Source: DZS

2.6.2 Social security benefits

The social security benefits in Croatia include sickness (including work-related accidents and illnesses) and maternity benefits, disability benefits, old-age benefits, survivors' pensions, unemployment benefits and family benefits.¹⁷²

Sickness and maternity leave benefits are part of the social insurance system. Both have been reformed several times since 1996.¹⁷³ Farmers, pensioners, unemployed persons, persons entitled to occupational rehabilitation, and children up to the age of 18 (the age of 26 if they are students), disabled former military servicemen without resources, the dependents of insured persons, and voluntarily insured persons are eligible for medical benefits. Employed persons are entitled to receive financial compensation and medical benefits. Employers contribute to 15% of the income, plus 0.5% of the income for work injury and work related illness, while employees do not contribute. The **government** contributes on behalf of certain categories of persons and finances new-born child assistance, additional maternity leave, obligatory maternity leave for unemployed mothers, sick leave for war veterans, and adoption leave.

Cash sickness benefits can be provided for up to 6 months; thereafter, the invalidity commission of the Croatian Pension Insurance Institute decides whether the insured is permanently disabled, cured, or in need of further treatment. In the latter case, an additional six-month period of temporary disability is paid.

The sickness benefit varies between 70% and 100% of the average monthly earnings in the previous 6-month period. 100% of the average monthly earnings is paid for an incapacity that is the result of a work injury or an occupational disease, participation in the Homeland War, pregnancy, childbirth, the donation of transplantation tissues or organs, or if nursing a sick child up to the age of 3. The employer pays for the first 42 days, except if the sick leave results from having participated in the Homeland War, pregnancy, or maternity leave, in which case the cost is met by the Croatian Institute for Health Insurance at the expense of the state budget.

A maternity benefit equal to the employee's salary is payable until the child is aged 6 months (beginning 28 to 45 days before the expected date of childbirth). An additional

¹⁷² Social Security Programs Throughout the World: Europe 2002 – Croatia, <http://www.ssa.gov/policy/docs/progdsc/ssptw/2002-2003/europe/croatia.html>.

¹⁷³ 1996 (maternity), with 2004 amendment; 1997 (health care); 2001 (health insurance), implemented in 2002, with amendments; 2002 (contributions), with 2002 and 2004 amendments; 2003 (health care); 2004 (patients rights); and 2005 (compulsory insurance contribution).

benefit (ranging from approx. EUR 214 to EUR 300) is payable until the child is one year old (age 3 for twins). Unemployed mothers receive 1,600 HRK (approx. EUR 214) a month during the first six months of the maternity period. **The newborn child assistance is a lump sum of approximately EUR 200.**

Medical benefits (for employed persons and dependents) are provided by the public and private health institutions that are contracted with the Croatian Institute for Health Insurance. The benefits include primary and specialist treatment, hospitalization, orthopaedic and other aids, dental care, approved pharmaceuticals, laboratory services, maternity care, preventive care services, emergency aid, rehabilitation services, appliances, and transportation.

Cost sharing by patients varies according to the nature of the service provided. Services are free for children younger than 18, persons with a low income, disabled persons needing constant assistance, disabled Homeland War veterans, persons registered at the Croatian Institute for Health Insurance as unemployed, and voluntary blood donors who have made 35 donations (men) or 25 donations (women).

A **two-pillar old age pension system** (social insurance and the mandatory individual account system) was implemented in two stages in January 1999 and January 2002. Persons older than 50 when the new system was implemented are insured under the first-pillar social insurance only and receive a regular pension. Those between the ages 40 and 50, who were already insured under the first-pillar social insurance, could opt to join the two-pillar mandatory system until June 30, 2002.

The social insurance is funded by the 20% contribution of gross earnings for those insured only under the first pillar. The contributions of persons insured under the first pillar and the mandatory individual account system are also 20% of gross earnings, 15% to the social insurance and 5% to the individual account. *The government covers* all or part of the first-pillar costs for military officers, policemen, judiciary officials, parliamentary deputies, members of the government, and disabled war veterans.

The minimum qualifying conditions for old age pension are the age of 65, with 15 years of insurance coverage for men, or the age of 60, with 15 years of insurance coverage, for women.¹⁷⁴ The qualifying conditions for early pensions until 31 December 2007 were the age of 59, with 35 years of insurance coverage (men), or the age of 54, with 30 years of

¹⁷⁴ These minimum qualifying conditions apply since 1 January 2008. Until then, the requirement was the age of 64 and 16 years of insurance coverage for men, and the age of 59 with 16 years of insurance coverage for women.

insurance coverage (women). The early retirement age will increase by six months each year until it reaches the age of 60 (men), or the age of 55 (women) in 2008. The same conditions apply for social insurance pension and social insurance.

Insured persons may be eligible to receive different combinations of social insurance and individual account benefits. For the coverage periods under the social insurance system before 2002, the insured receives a regular pension benefit; for the coverage periods under the social insurance system from 2002, the insured receives a basic pension benefit.

For the periods of insurance coverage under the social insurance system before 2002, the minimum pension is calculated as 0.825% of the adjusted average gross salary of all employees in 1998 for each year of the insurance coverage, up to a maximum of 30 years. For insurance coverage periods exceeding 30 years, the calculation is based on half of the amount for each year of the insurance coverage exceeding 30. The maximum pension depends on the length of the insurance coverage period and previous earnings, up to a ceiling.

Early pension is reduced by 0.3% for each month the pension is paid before the normal retirement age. This reduction is permanent and continues after the recipient reaches the normal retirement age. The benefits are adjusted every six months according to an index based on the changes in the cost of living and the national average gross earnings.

Basic old-age pension is based on the average gross salary of all employed persons in the preceding year, the number of the years of insurance coverage in the new system, and previous earnings, up to a ceiling. The benefits are adjusted every six months according to an index based on the changes in the cost of living and the national average gross earnings. The pension is based on the accumulated assets in the individual account and the average life expectancy at retirement.

Disability benefits are payable for a permanent reduction in, or loss of, the ability to work resulting from an occupational or non-occupational injury or disease. Higher awards are made for a disability that is the result of a work injury or an occupational disease. There are several types of disability benefits: general disability pension, *occupational (partial) disability pension*, *occupational rehabilitation and salary compensation* and *compensation allowance for a physical injury*.

The disability pension depends on the level of wages earned in relation to the average wage of all employed persons, the length of the insurance coverage period (except for a work injury or an occupational disease), and the assessed degree of disability (the total loss of, or permanent reduction in, the capacity to work). In most cases, benefits are paid under the first pillar.

For a disability caused by a work injury or an occupational disease, the minimum number of years used for pension calculation purposes is 40. The amount of the pension is calculated according to the years of the insurance coverage and the value of the pension per qualifying year. The full amount is paid for a general disability; the occupational disability pension is 80% of the general disability pension and 33.3% if the pensioner is still employed. The general disability pension is not payable while the beneficiary is employed.

The minimum pension is calculated as 0.825% of the adjusted average gross salary of all employees in 1998 for every year of the insurance coverage, up to a maximum of 30 years. For coverage periods exceeding 30 years, the calculation is based on half of the amount for each year of insurance coverage exceeding 30. HRK 46.92 is paid per year for the first 30 years of insurance coverage and 23.46 Kunas for each year of the insurance coverage exceeding 30 (July 2005). The maximum pension depends on the length of the insurance coverage period and previous earnings, up to a ceiling.

Occupational rehabilitation and salary compensation is the same as the occupational disability pension unless the disability was caused by a work injury or an occupational disease. In such a case, it is the same amount as the general disability pension, based on 40 years of insurance coverage.

Compensation allowance for a physical injury depends on the assessed degree of physical injury resulting from a work injury or an occupational disease. There is no minimum qualifying period. The allowance is payable during employment or self-employment and thereafter, for the duration of one's lifetime.

Survivor pension is payable to the eligible surviving spouse (aged 50 or older, disabled, or caring for eligible children; a woman who is widowed at the age of 45 becomes eligible when reaching the age of 50) or dependent children (up to the age of 15, age 18 if unemployed, age 26 if they are students, no limit if they are disabled) of a pensioner, an occupational rehabilitation beneficiary, or a person that had completed 5 years of insurance coverage or a 10-year qualifying period, or met the qualifying period conditions for a disability pension. There is no minimum qualifying period if the death resulted from a work injury or an occupational disease.

The amount is based on the old-age or disability pension paid or payable to the deceased and the number of survivors. The minimum number of years of insurance coverage for pension calculation purposes is 21. If the insured's death was the result of a work injury or an occupational disease, the minimum number of years of insurance coverage for pension calculation purposes is 40. In most cases, benefits are paid under the first pillar.

Unemployment benefits are part of the social insurance system. The employer pays 1.7%, and the government provides periodic subsidies and the total or partial cost of benefits for certain categories of persons. Eligible are persons between the ages 15 and 65, with 9 months of employment in the last 24 months. The insured must register with the Employment Institute in the first 30 days of the unemployment. There is no qualifying period for unemployed mothers caring for children younger than the age of one. Persons whose employment ceased as a result of misconduct or by agreement with the employer are not entitled to unemployment benefits.

Unemployed workers with 35 years (men) or 30 years (women) of employment are covered until they are reemployed. Benefits may be paid to women during their pregnancy and until the child is one year old if there is no entitlement to benefits under any other program. The benefit may be paid during temporary incapacity for work for up to 3 months. Unemployed persons of retirement age are also entitled to unemployment benefits until the minimum insurance coverage period for the old-age pension is satisfied, up to a maximum of 5 years. The beneficiaries of the unemployment benefit who became unemployed because of the restructuring of their place of employment or because of unforeseen personal circumstances are eligible for a lump sum payment.

Unemployment assistance is payable to unemployed persons who participate in vocational training. **The reimbursement of travelling and removal costs is payable** if the costs are incurred as a result of finding new employment and having to relocate from one's regular place of residence.

The government bears the costs of **family allowances**. Family allowances are part of the social assistance system and are subject to an income ceiling. They are paid to parents (including foster parents, tutors, stepparents, and grandparents) of children younger than 15 (regardless of whether they are at school) and children older than 15 if they are full-time students, incapacitated, or disabled. The income ceiling is 40% of the state budget base.¹⁷⁵

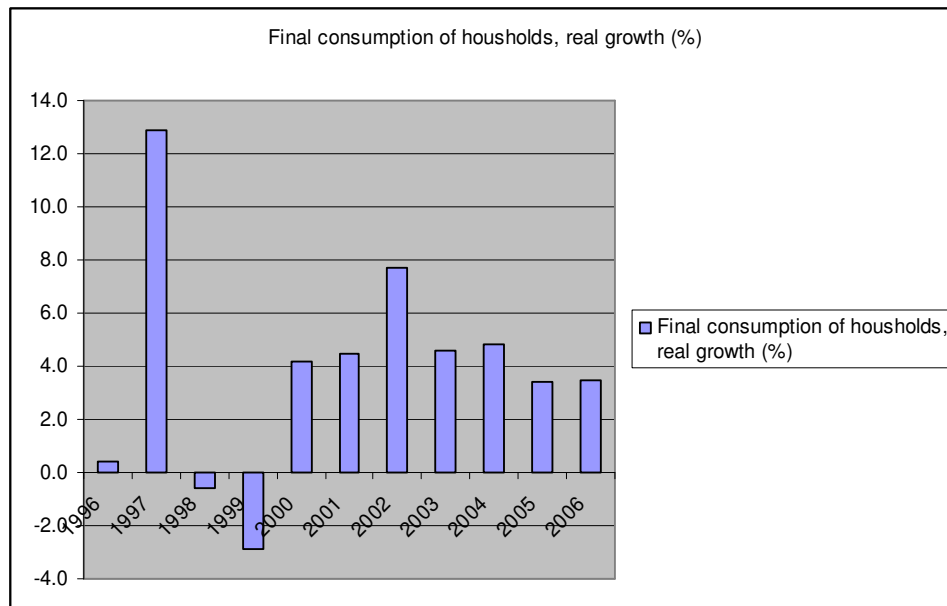
¹⁷⁵ Social Security, Social Security Online <http://www.ssa.gov/policy/docs/progdesc/ssptw/2002-2003/europe/croatia.html>.

2.6.3 Household consumption

The Central Bureau of Statistics produces the monthly consumer price index, with expenditure weights (updated every five years) derived from the 2001 Household Budget Survey. In between rebating, the weights are price-updated annually to the December of the previous year. A harmonized index of consumer prices (HICP) is also calculated in line with the Eurostat methodology, but it is not released.

The final consumption of households has been growing since 2000 at the average rate of 4.75.

Figure 2.29 Final consumption of households, real growth, %



The highest share (32.5% on average during 2002-05) is spent on food and beverages, housing (13.5%) and transportation (11.3%). Education represents 0.7% of personal consumption, while alcoholic drinks and tobacco constitute 4% (Table 2.29).

Table 2.29 Personal consumption, average per household, 2002-05

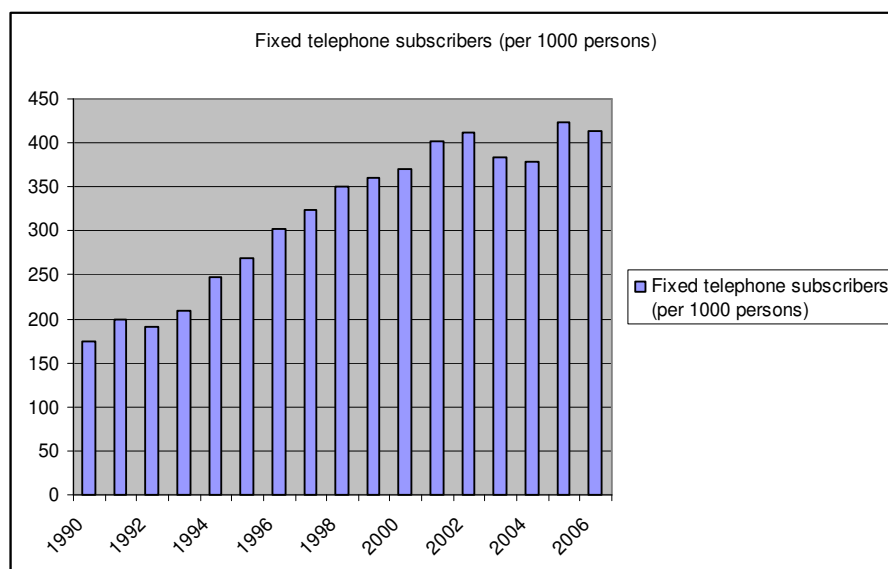
	2002	2003	2004	2005
Personal consumption, total, Kuna	64736	65593	68525	69668
Food and beverages, % of total	32.15	32.6	31.5	33.21
Alcoholic drinks and tobacco, % of total	3.98	4.19	4.06	4.00
Clothing and footwear, % of total	8.86	8.33	8.06	7.72
Housing and energy ¹⁷⁶ , % of total	13.71	13.78	13.02	13.56
Furniture, equipment and maintenance, % of total	5.52	5.37	5.35	5.09
Health, % of total	2.23	2.11	2.4	2.29
Transportation, % of total	11.07	11.45	11.85	10.86
Communication, % of total	4.81	4.97	5.35	5.32
Recreation and culture, % of total	6.42	6.18	6.45	6.22
Education, % of total	0.68	0.67	0.74	0.76
Hotels and restaurants, % of total	3.16	2.76	3.41	3.39
Other goods and services, % of total	7.41	7.59	7.72	7.58

Source: DZS

2.6.4 Stock of consumer durables

The stock of consumer durables has increased considerably since the beginning of the transition period. The number of fixed telephone subscribers has almost doubled between 1993 and 2001 and has been stagnating since.

Figure 2.30 Fixed telephone subscribers, per 1000 persons

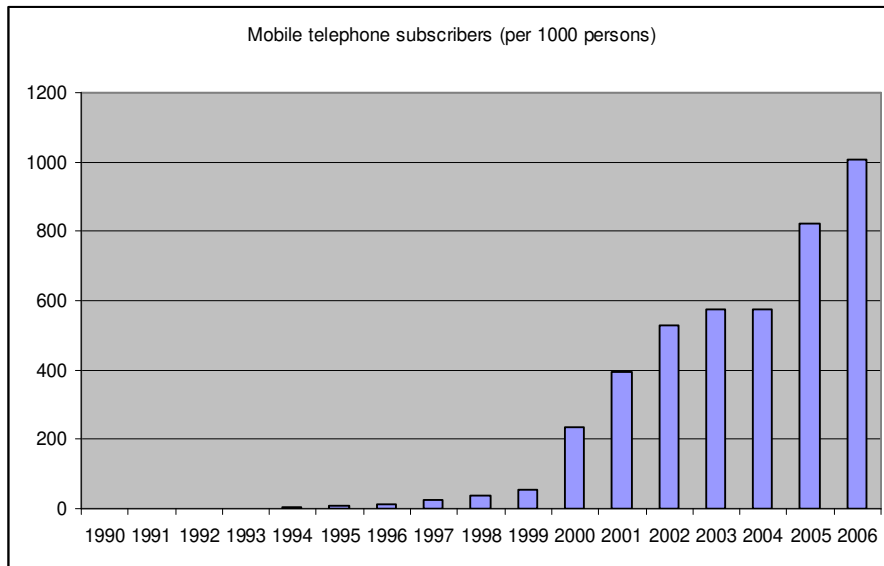


Source: WIIW

¹⁷⁶ Housing expenditures do not include imputed rent

Since 2000, the mobile penetration rate has increased significantly.

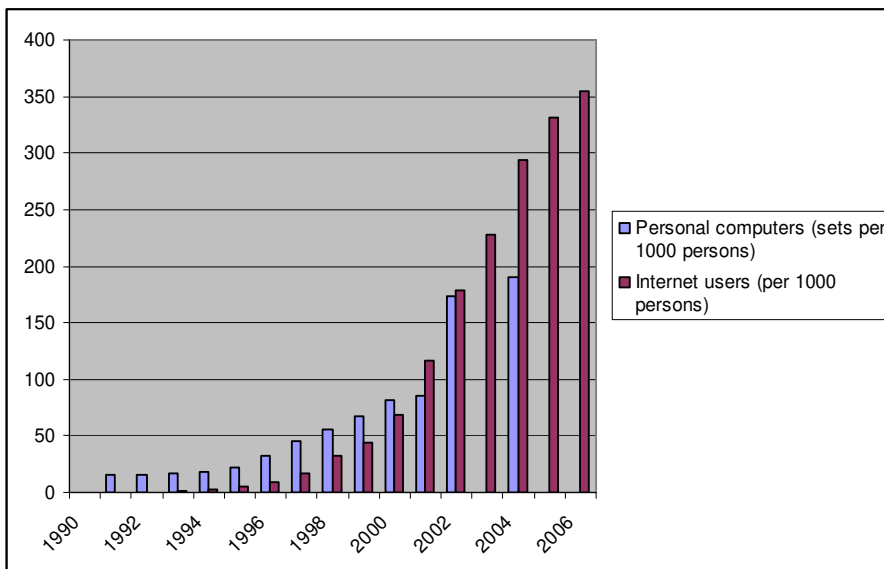
Figure 2.31 Mobile telephone subscribers, per 1000 persons



Source: WIW

The use of personal computers and the internet has started spreading since 2000 and has been growing rather fast since. In 2004, the number of internet users (294) was higher than the number of TV subscribers (251) per 1000 persons.

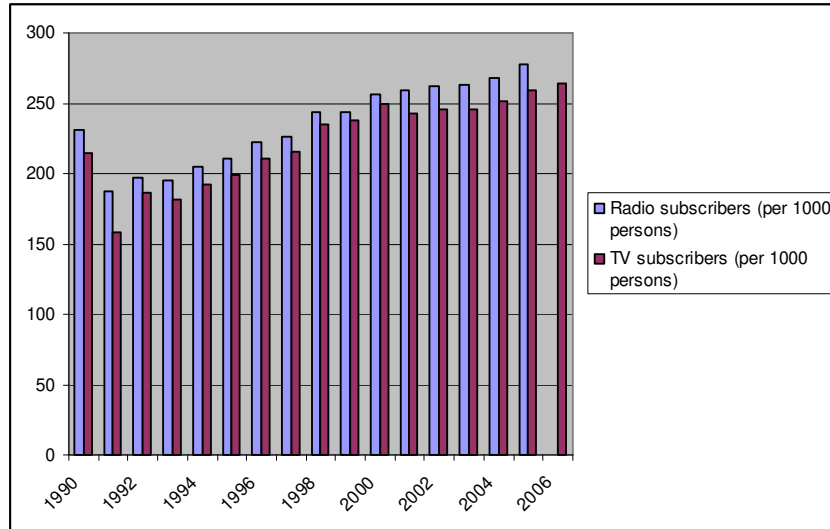
Figure 2.32 Number of personal computers and internet users per 1000 persons



Source: WIW

The number of radio subscribers was roughly 6% higher than the number of TV subscribers in the period 1990-2006. The growth has been continuous, but rather limited.

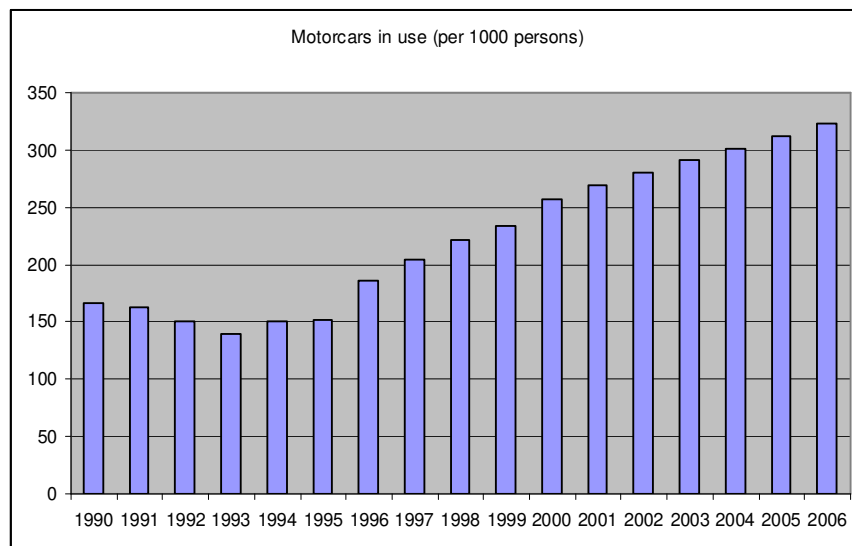
Figure 2.33 Number of radio and TV subscribers per 1000 persons



Source: WIIW

As regards motorcars in use, the number was falling in the period 1990-93. Since 1993, the number grew at 7% on average (yoy) and doubled by 2003. The number of motorcars in use is higher than the number of radio subscribers per 1000 persons.

Figure 2.34 Number of motorcars in use per 1000 persons

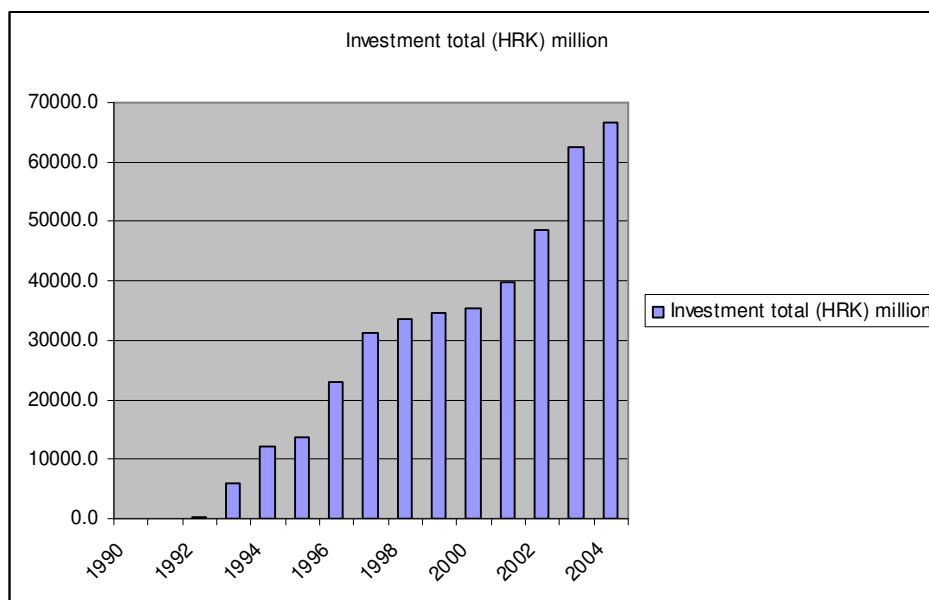


Source: WIIW

2.6.5 The evolution of investments

The growth of gross fixed capital formation has been uneven during the period 1995-2004 (Table 2.30), ranging between 0.8% in 2000 and 43.5% in 1996.

Figure 2.35 Investment ratio



Source: WIIW

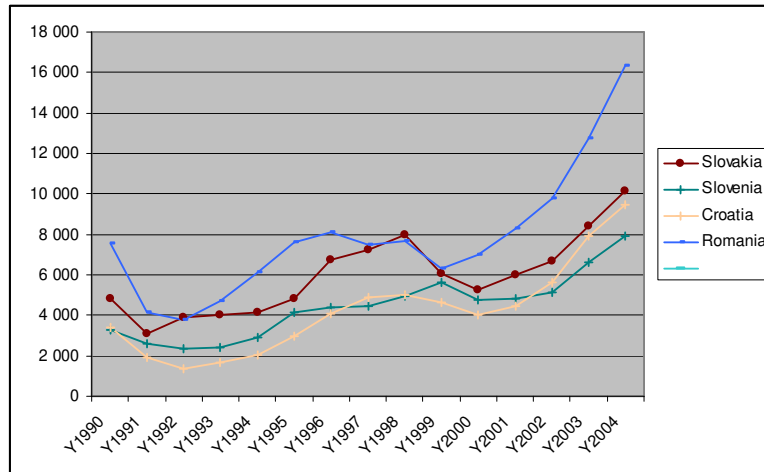
The pattern of gross capital formation in Croatia since 1990 was the same as in Slovakia, Slovenia, the FYR of Macedonia and Romania.

Table 2.30 Gross fixed capital formation, million Kuna, % change

	Gross Fixed Capital Formation	Change
1995	15 398.00	26.1%
1996	22 089.00	43.5%
1997	29 936.00	35.5%
1998	32 066.00	7.1%
1999	33 025.00	3.0%
2000	33 280.90	0.8%
2001	36 984.10	11.1%
2002	44 114.20	19.3%
2003	53 167.50	20.5%
2004	57 141.10	7.5%

Source: Econstat

Figure 2.36 Gross fixed capital Formation: Croatia, Slovenia, Romania, and Slovakia, million USD

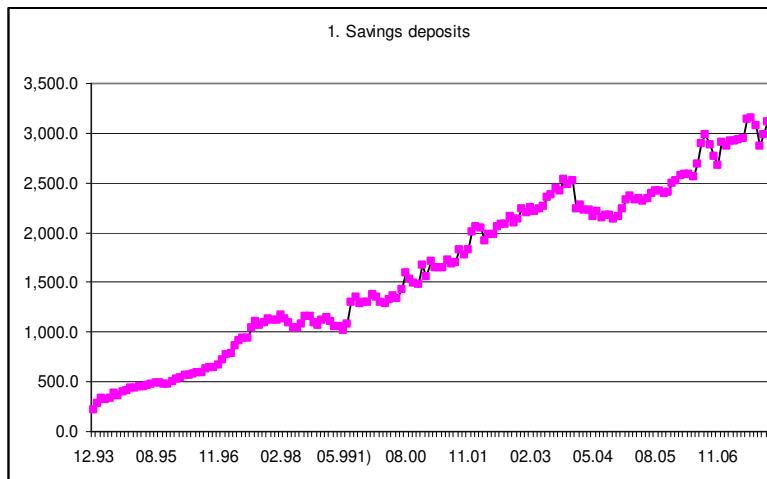


Source: UNCTAD

2.6.6 The development of savings

Savings have been increasing since 1993. Following the banking crisis, deposits dropped in 1998-2000 and in 2002. The Euro conversion process in late 2001 brought a substantial inflow of deposits, as the Euro-legacy currency held 'in mattresses' flowed into bank deposits. The foreign exchange deposits grew by 2.8 billion Euros, but after this extraordinary inflow, some of the deposits were redrawn in 2002, which was one of the periods when the savings decreased. During the whole period of 1993-2007, savings increased 15 times.

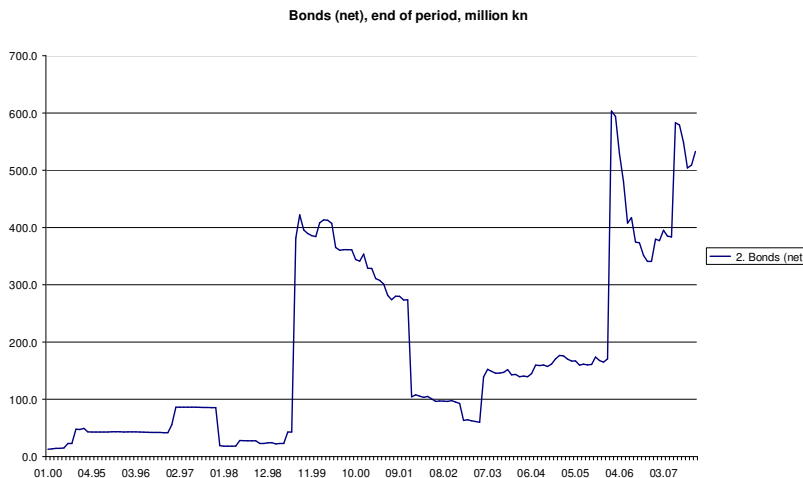
Figure 2.37 Development of savings, million Kuna, end of period



Source: CNB

Net bonds vary significantly over time. In 2003, the first government Kuna Bonds were issued (HRK 1 billion, equivalent to EUR 133 million), carrying a 6.125% interest rate with a 5-year maturity. This was in line with the government's commitment to shifting from foreign to domestic borrowing and helping the development of the local capital market. The main clients were institutional investors, such as pension funds.

Figure 2.38 Bonds, net, end of period, million Kuna



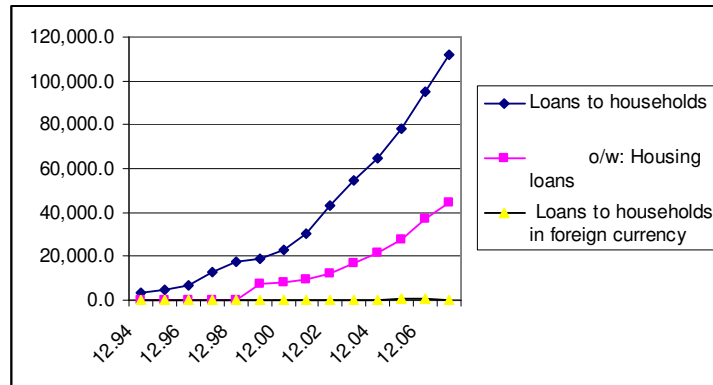
2.6.7 Credit to Households

In Croatia, as in other transition countries, bank lending accelerated sharply following the restructuring of the banking system. A striking feature of the acceleration in bank lending has been the very rapid growth in lending to households, albeit from a low base. Like most of the transition countries, Croatia emerged from the early transition with a minimal stock of household loans, roughly 5% of the GDP in 1995. Since then, household lending has grown rapidly, rather faster than lending to enterprises.

The first phase of Croatia's lending boom was in 1995-98. A high deposit growth due to the repatriation of deposits held abroad after the ending of the hostilities and the strong foreign borrowing after Croatia received an investment grade credit rating in January 1997 enabled funding. In this period, credits to households grew at 35%, 40% and 93% (yoy, respectively). The second credit boom started following the large-scale entrance of foreign

banks. A significant share of credit is housing loans. Household lending was a bit more than 34% of the GDP at the end of 2005.¹⁷⁷

Figure 2.39 Credit to households, million Kuna, end of period, 1993-2007



Source: CNB

Credits to households represent roughly half of the total credits approved. The share of housing loans is increasing, but other loans (e.g. consumer loans) are still higher. Housing credits are the fastest growing category, and the interest rates on this type of credit are the lowest.

Table 2.31 Credits to households, share in total, 2004-07

	2004	2005	2006	2007
Companies	40.5	39.3	40.4	38.9
Household	49.3	49.4	49.2	50.5
-housing	16.3	17.5	19.1	20.5
-other	33.0	31.9	30.1	30.0

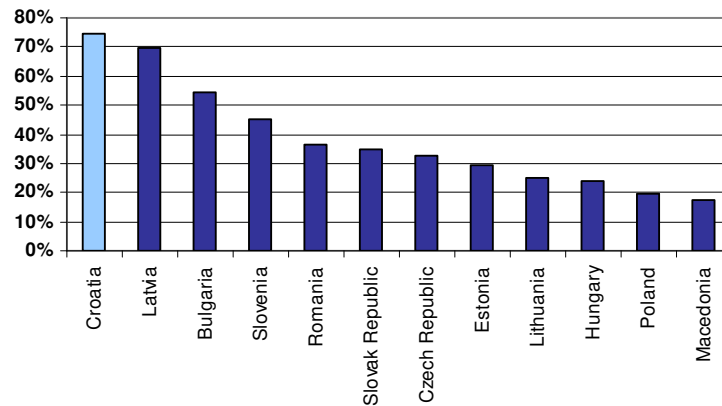
Source: Croatian National Bank

2.6.8 Currency substitution

The Croatian economy is highly Euroized compared to other transition countries¹⁷⁸.

¹⁷⁷ C.f. Evan Kraft and Ljubinko Jankov, “Lending Booms, Foreign Bank entry and Competition: The Croatian Case.” (paper presented at the Banking and the Financial sector in transition and emerging market economies, Dubrovnik, June 26-28, 2003).

Figure 2.40 The degree of dollarization in transition economies



Source: Feige, E. (2002)

Some 80 percent of deposits in the banking system are denominated in foreign currencies or are indexed, of which approximately 80 percent is in Euros.

Figure 2.41 Currency subsidisation



Source: Croatian National Bank

The level of currency substitution is not only high, but also persistent. The persistence of currency substitution is a well-known phenomenon, which is usually referred to as hysteresis

¹⁷⁸ Boris Vujčić, “Monetary policy and management of capital flows in a situation of high euroisation - the case of Croatia,” *BIS papers* no 17: 79-98 (2003).

or the irreversibility of currency substitution. The reasons for relying on foreign currency include a long history of macroeconomic instability dating back to ex-Yugoslavia: high inflation, frequent devaluations, and partial foreign exchange deposit expropriations. In fact, even a significant, at times very large interest premium on the domestic currency denominated instruments could not reverse the high level of currency substitution.

Not only are banking sector liabilities predominantly in Euros, but the Croatian National Bank (CNB) estimates that, even after the Euro changeover, foreign currency cash in circulation is larger than the domestic cash. The CNB estimates that there is over EUR 2 billion of foreign currency cash compared to the EUR 1.5 billion in the domestic currency.

2.6.9 Real estate sector

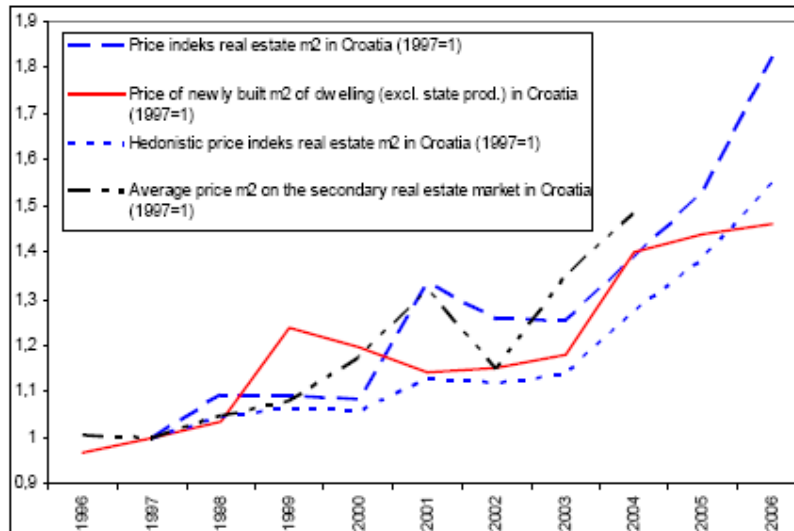
The real estate market in Croatia started to develop in the second half of the 1990s, following the privatisation of the housing and commercial property stock. The privatisation of housing led to an increase in the already high proportion of both privately-owned and owner-occupied housing. According to the 2001 census, 96% of the 1.4 million permanently occupied dwellings in Croatia were owned by private individuals, and 83% were owner-occupied dwellings. For comparison, in Western Europe the share of housing owned by private individuals ranges from about 60% in Austria and Sweden to 90-95% in Belgium, Greece, Spain and Portugal, while the share of owner-occupied housing ranges from 38% in Germany to 80% in Ireland. Croatia is in this respect similar to some other CEE countries, where privatisation has also resulted in a high level of owner-occupied housing.¹⁷⁹

The real estate market in Croatia is relatively small – the construction and real estate industries account for around 13% of the GDP, compared with 20-25% of the GDP in many industrial countries. Only the prices of the newly built and sold dwellings are published regularly by the Croatian Bureau of Statistics. The price index published by the rental agencies and the media since 2006 are based on the supply-side requirements. The index does not consider the period needed for rent or sale, and as result, the prices might be overestimated and not very reliable. In addition, commercial and residential property rental is a sector with a significant informal economic activity.

¹⁷⁹ Dubravko Mihaljek, “Free movement of capital, the real estate market and tourism: a blessing or a course for Croatia on its way to the European union,” in *Croatian Accession to the European Union*, ed. Katarina Ott (Zagreb: Institute for Public Finances, 2005) , 185-228.

As a result, there is little reliable information about prices. According to the trade union cost of living estimates, the rental price of a 60 square meter apartment in 2004 and 2005 was 240 EUR/month, which increased to 250 EUR/month in 2006. The prices in Zagreb are estimated to be EUR 100 higher. The real average price of a square meter of a newly built and sold dwelling has been increasing since 1994¹⁸⁰

Figure 2.42 Housing price index estimates



Source: Tica. *Stambeno tržište u Hrvatskoj (Housing market in Croatia)*, available from <http://web.efzg.hr/dok/MGR/tica/Stambeno%20tr%C5%BEi%C5%A1te%20u%20Hrvatskoj.pdf>

2.6.10 The Stock Exchange and the money market

The Zagreb Stock Exchange or ZSE (Croatian: Zagrebačka burza) is a stock exchange which operates in Zagreb, Croatia. It was established in 1991. In March 2007, the ZSE was merged with the other Croatian stock exchange, VSE, to form a unique Croatian capital market, the largest one in the region. As of November 23 2007, the ZSE includes the stocks of 383 companies, with a market capitalization of 369.6 billion Kuna (USD 74.6 billion, EUR 50.4 billion).

¹⁸⁰ Josip Tica, "The Macroeconomic Aspect of Croatian Market," *Ekonomski pregled* no. 55 (7-8), (2004), 641-659. http://hrcak.srce.hr/index.php?show=clanak&id_clanak_jezik=24733.

Table 2.32 The Zagreb Stock Exchange, capitalization and CROBEX

		1997	2001	2002	2003	2004	2005	2006**
Stock market CROBEX index	1000*	1035	1173	1185	1565	1998	2872	
Zagreb Exchange, capitalisation, % GPD	stock	16	22	25	41	50	62	

* 1000 on 1 July 1997

**in Q2 2006

Source: IMF, *Staff Report for the 2006 Article I Consultation, January 19 2007.*

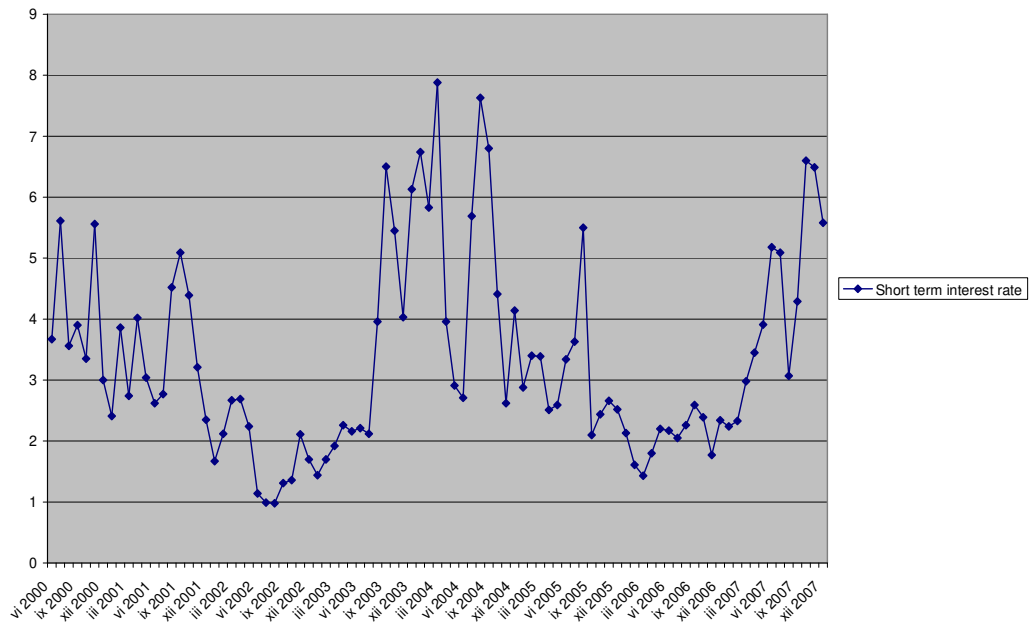
The ZSE has three active quotations: Quotation I, Quotation TN, and Quotation JDD. In 2003, there were three equities listed in the Quotation I category. The issuers of any first quotation equities in Croatia are required by law to publish financial statements and data on dividends on a quarterly basis. The most important requirements for the Quotation I stocks of the ZSE are the free transferability of the equities, the listing of the whole class of securities, a prospectus, the financial statements of the issuer to be audited for three years prior to the listing, minimum three years of operation, at least 25 percent of securities to be in public hands (owned by non-dominant shareholders), and the expected market capitalization of the issuer's stock to be at least 10 million Euros.

The official equity index of the ZSE is CROBEX, a capitalization weighted index, which started at 1000 points on September 1, 1997. In 2003, eleven equities were included in the index, two from the Quotation I category.

The Zagreb Money and Short Term Securities Market was founded in 1990 pursuant to the Money Market Act, as an organized and regulated market for public trading by money market participants. The Money Market's core business activity is the organized matching of demand and supply of money market instruments: money (both Kuna and foreign exchange funds), short-term securities, long-term securities in the last year prior to maturity and other money market instruments. The Money Market participants are banks and other financial institutions (building societies, insurance companies, investment and pension fund management companies, funds and others), the Croatian National Bank and the Ministry of Finance. In February 2004, the Money Market launched an electronic trading system known as SETT, which enables simultaneous trading by all participants in various money market instruments electronically, in real time. The SETT system also provides prompt information to all participants on current market developments, supply, demand and transactions. The short-term securities transactions conducted by the means of the SETT

system are automatically registered in the Clearing and Settlement system of the Central Depository Agency.

Figure 2.43 Money market interest rates

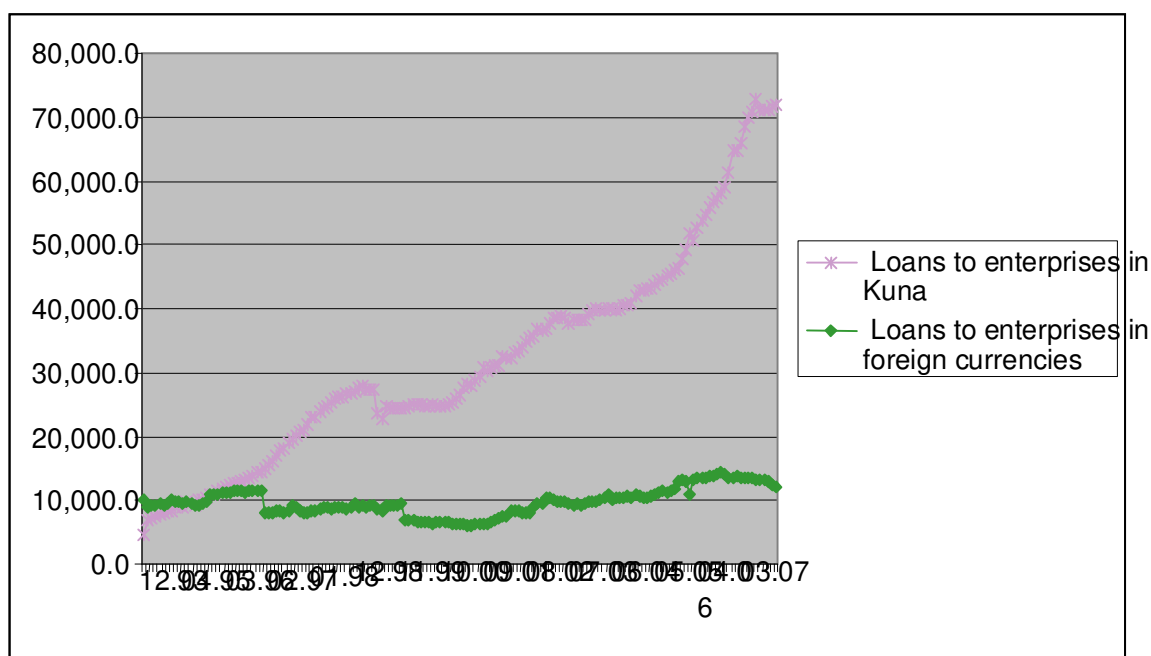


Source: www.trzistenovca.hr.

2.6.11 Corporate sector banking

The loans to enterprises have been increasing at a slower pace than the ones to households. In December 2007, the ratio of loans to enterprises/households in Kuna was 0.65, while it was 3.2. in foreign currencies. In 2004, the loans to enterprises were significantly bigger than the ones to households: more than 3000 times in the domestic and 2.4 times in foreign currencies.

Figure 2.44 Loans to enterprises, end of period, million Kuna



Source: Croatian National Bank

According to the EBRD estimates, factoring in Croatia is underdeveloped. In 2005, factoring in Croatia represented 0.5 % of the GDP, while factoring in the Czech Republic was 2.7% of the GDP and in Slovakia 2.1%. According to the country strategy, the EBRD will help the development of financing for leasing companies and other non-bank financial institutions, such as factoring companies.¹⁸¹

Based on a factoring study financed by the Austrian government in 2001, the regulatory issues that inhibit the growth of this industry were identified, and the necessary amendments to the legislation in order to overcome them were drafted. The findings were presented to the Croatian Ministry of Finance and the National Bank of Croatia, and the National Bank issued a regulatory decree reducing the starting capital requirements for factoring from USD 10.5 million to USD 2 million, putting factoring entities in Croatia on a more even footing with factoring companies internationally. A second decree enabled other financial institutions in Croatia such as leasing companies to establish factoring.

The first factoring company was established at the end of 2003, and some banks have also established their factoring companies.

¹⁸¹ EBRD, *Croatia: Country strategy* <http://www.ebrd.com/about/strategy/country/croatia/index.htm>

Table 2.33 Factoring in Croatia, million EUR

	Domestic	International	Total	% GDP
Croatia	165	10	175	0.5
Austria	3 730	543	4 273	1.7
Czech Republic	2 370	535	2 882	2.7
Hungary	1 750	70	1 820	1.9
Slovakia	585	245	830	2.1
Slovenia	200	30	230	0.8

Source: World Bank

In 2004, factoring reached EUR 28 million, in 2005, HRK 1 billion, and estimates for 2006 are roughly HRK 1.5 billion.

2.6.12 Forecasts

The global developments make access to foreign capital more complicated. The recent inflation growth has caused a decrease in real interest rates and real appreciation. The Croatian Nation Bank tries to keep the nominal exchange rate stable and the exchange rate ceiling (7.35) should limit the depreciation expectations. The CNB will also maintain the limits on bank activities and limit the nominal growth of investment to 12%. The identified risks relate to a possible liquidity crisis related to foreign debt refinancing and the financing of imports.¹⁸²

The changes in the monetary policy are not likely, as long as the credit growth supports a high current account deficit, increasing prices of securities, real estates, as well as goods and services. It is also expected that the government will introduce policies aimed at limiting inflation, such as limiting the central government deficit, price control, and limiting the wage growth. Such measures are necessary in the pre-accession phase. Decreasing the central government budget deficit in the pre-accession period would help bearing these costs in the first years of the membership. It is expected that in the first years following the accession, the impact of the EU membership on the consolidated general government balance will be negative, resulting from a loss of tariff income and liquidity relating to the collection of the value added tax for export to the EU.

The most significant financial effects of joining the EU relate to the contributions to the EU budget, participation in the EU structural policies, infrastructure related costs, the implementation of the common external tariff, the harmonisation of the fiscal system,

¹⁸² Zeljko Rohatinski (Governor of the CNB), *Status of banking sector and monetary policy*, February 2008.

budgetary effects related to the agricultural support, and the decrease of state aid. The expected indirect effects relate to higher growth rates, structural reform and the improvement of the country's credit rating, which could contribute to decreasing interest rates. In the medium to long term, the EU membership should bring financial benefits for Croatia.¹⁸³

¹⁸³ Economic Institute Zagreb, *Pristupanje Europskoj uniji - očekivani ekonomski učinci*, (Zagreb: Economic Institute Zagreb, 2007) <http://www.eizg.hr/Item.aspx?Id=336&lang=1>.

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CHAPTER 3 - RELATIONS WITH THE EUROPEAN UNION

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3.1 The governmental organization and institutional structure of EU relations

3.1.1 Governmental bodies responsible for EU relations

The main central government bodies responsible for EU relations are (i) the Ministry of Foreign Affairs and European Integration and (ii) the Central Office for Development Strategy and Coordination of EU Funds. There is a separate structure for accession negotiations, which is highly centralised and dominated by the Ministry of Foreign Affairs and European Integration. Line ministries have a rather indirect role.

Regarding the internalisation of European affairs, there are two central agencies that deal with specific issues - the Central Agency for Financing and Contracting of the Programmes and the Projects of the European Union, and the Agency for Mobility and EU Programmes. A National Fund located within the Ministry of Finance administers the pre-accession funds allocated under the responsibility of a National Authorising Officer.

3.1.1.1 The Ministry of Foreign Affairs and European integration

The Ministry of Foreign Affairs and European Integration was established in an ad-hoc decision in 2005, by the merger of the Ministry of Foreign Affairs and the Ministry for European Integration.

The main tasks of the Ministry of Foreign Affairs and European Integration related to European integration are:

- the implementation of agreements with the EU,
- the coordination of the activities of governmental, regional and local bodies related to the EU,
- the coordination of the process of the alignment of the Croatian legal system with that of the EU,
- the coordination of the translation of the EU *acquis* into Croatian, and that of the relevant Croatian legislation into one of the official EU languages; the publication of the official translations of the EU documents
- the organisation and implementation of education and training projects in the field of European integration,
- providing analytical support to the integration process
- the implementation of the communication strategy aimed at informing the Croatian public about the European integration process of the Republic of Croatia. This task

also includes preparing the decision makers for the role that they have in the integration process¹⁸⁴.

Within the Ministry of Foreign Affairs and European Integration are the Office of the Chief Negotiator and the Secretariat of the Negotiating Team. These two organisational units are parts of the separate structure for the accession negotiations.

3.1.1.2 The Central Office for the Development Strategy and Coordination of the EU Funds

The Central Office for Development Strategy and Coordination of EU Funds is responsible for the overall coordination and management of the EU pre-accession funds available to Croatia. The Office also coordinates the development of the Strategic Coherence Framework as a basic strategic document for the use of the Instrument for pre-Accession Assistance (IPA). It is headed by a State Secretary, who is directly responsible to the Prime Minister.

3.1.1.3 The structure for accession negotiations

A separate structure for the accession negotiations was established in 2005 by a governmental decision¹⁸⁵. It consists of:

- the State Delegation of the Republic of Croatia for Negotiations on the Accession of the Republic of Croatia to the European Union;
- the Coordinating Committee on the Accession of the Republic of Croatia to the European Union,
- the Negotiating Team for the Accession of the Republic of Croatia to the European Union
- the Working Groups for the preparation of the negotiations on the individual chapters
- the Office of the Chief Negotiator and
- the Secretariat of the Negotiating Team.

¹⁸⁴ “Act amending the Act on the organization and scope of work of the central government’s bodies,” *Official Gazette*, no. 22 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0388.htm>.

¹⁸⁵ “Decision on establishing structure for negotiations of the Republic Croatia on the EU accession,” *Official Gazette*, no. 49 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0950.htm>.

The State Delegation of the Republic of Croatia for Negotiations on the Accession of the Republic of Croatia to the European Union conducts direct political talks and negotiations with the EU. It is responsible for the success of the negotiations for all chapters. The State Delegation is responsible to the government. It acts pursuant to the negotiating guidelines that are adopted by the government, as well as pursuant to the conclusions of the Coordinating Committee for the Accession of Croatia to the European Union.

The State Delegation is obliged to provide reports on the course of negotiations to the government following each meeting of the bilateral Intergovernmental Conference between the Republic of Croatia and the EU Member States held at ministerial level. In addition, the State delegation is obliged to provide special reports at the government's request.

The State delegation consists of six members:

- the Minister of Foreign Affairs and European Integration, who is the head of the State Delegation,
- the deputy of the head of the State Delegation and the Chief Negotiator,
- two deputies of the Chief Negotiator,
- the chief of the Mission of the Republic of Croatia to the European Union, and
- a secretary of the negotiating team.

The Head of the State delegation represents Croatia at bilateral intergovernmental conferences and supervises and guides all negotiation chapters. The deputy of the head and the Chief Negotiator is an ambassador in the Mission of the Republic of Croatia to the European Union, appointed by the government.¹⁸⁶

The Coordinating Committee on the Accession of the Republic of Croatia to the European Union is a temporary working body of the government. It discusses all the issues relevant to the accession negotiations, including the draft proposals of the negotiating positions prepared by the negotiating team before their submission to the National Committee and to the government for adoption. It consists of the head of the delegation, the vice-presidents of the government and all the ministers. The chief negotiator is also a member. The negotiator of the respective field of discussion is a non-voting member of the Coordinating Committee.

¹⁸⁶ However, it is the president who, on the recommendation of the government and with the co-signature of the prime minister, appoints the ambassadors. ("Constitution of the Republic of Croatia," *Oficialna Gazeta*, no. 41 (2001), Article 98), <http://www.nn.hr/clanci/sluzbeno/2001/0705.htm>.

The Negotiating Team for the Accession of the Republic of Croatia to the European Union is responsible for the negotiations with EU institutions and the Member States of the European Union on all negotiating chapters (at an expert and technical level). It considers and adopts the draft negotiating positions and submits them to the Coordinating Committee on Accession of the Republic of Croatia to the European Union. The negotiating team also reports to the State Delegation and the government on the course of the negotiations.

The members of the negotiating team are responsible for the coordination of the particular clusters of the negotiating chapters and provide expert support to the Chief Negotiator, participate in negotiations on the basis of the instructions from the Chief Negotiator, coordinate the work of working groups for the preparation of negotiations on individual negotiating chapters, cooperate with EU coordinators in the state administration bodies, and are responsible for the drafting of the negotiating positions and related reports.

The 15 members of the negotiating team include:

- the Chief Negotiator,
- his two deputies,
- the members of the negotiation team, responsible for the coordination of the particular clusters of the negotiating chapters,
- the chief of the Mission of the Republic Croatia to the European Communities and
- a secretary to the negotiating team.

Eleven members of the negotiating team come from state institutions, two from the academic community and two from economic interest groups. They are appointed by the government upon the proposal of the head of the State Delegation, with the consent of the Chief Negotiator.

The Working Groups for the preparation of the negotiations on the individual chapters of the *acquis communautaire* participate in the analytical review and assessment of the harmonisation of the legislation of the Republic of Croatia with the *acquis communautaire* (screening) and in drawing up the draft proposals of the negotiating positions, in dialogue with state administration bodies or other bodies designated as competent authorities for the individual chapters of the *acquis communautaire*, and the EU Coordinator of the relevant body. The working groups have heads who administer their work in agreement with the members of the negotiating team in charge of coordinating the specific negotiation chapter.

The Office of the Chief Negotiator provides expert, technical and administrative assistance to the Chief Negotiator. According to the regulation on the structure of the Ministry for Foreign Affairs and European Integration, the Office of the Chief Negotiator is formally part of the Ministry of Foreign Affairs and European Integration. In view of the special nature of its work and in line with the activities of the Chief Negotiator, the Office operates within the government of the Republic of Croatia (in its premises) and within the Mission of the Republic of Croatia to the European Communities.

The Secretariat of the Negotiating Team provides expert technical and administrative support to the State Delegation, the negotiation team and the Working Groups. It also provides analytical reviews and analyses of the legislation, and it prepares the meetings of the State Delegation and the negotiating team. The Secretariat is part of the Ministry of Foreign Affairs and European Integration.

3.1.1.4 Other Bodies

By integration toward the EU, European affairs are gradually integrated in domestic issues. At the current stage, participation in some of the EU projects is open for Croatia. The management of these projects is gradually decentralised, and specific agencies are being established. The Commission has decided to confer the management of the PHARE and CARDS programmes to the Croatian institutions under the authority of the National Authorising Officer on 7 February 2006, while maintaining the ex-ante control requirement for tendering and contracting. This decision also allowed for the further decentralisation of the elements of CARDS 2003 and 2004. The following implementation structures exist in Croatia for the implementation of pre-accession assistance:

- - A National Fund (NF), located within the Ministry of Finance, to administer the funds allocated under the responsibility of a National Authorising Officer.
- - The Central Finance and Contracting Unit as the Implementing Agency for PHARE.
- - The Memorandum of Understanding on the Establishment of the National Fund, which provides a legal basis for the introduction of a decentralised implementation system for EU pre-accession assistance¹⁸⁷.

¹⁸⁷ European Commission, Report from the Commission to the Council and the European Parliament: 2006 Report on PHARE, pre-accession and transition instruments Country sections and additional information COM (2007) 679 final. (Brussels, 2007).

In 2007, two central agencies that deal with specific issues – the Central Agency for Financing and Contracting of the Programmes and Projects of the European Union, and the Agency for Mobility and EU Programmes - were created by separate laws.¹⁸⁸ They are established as public institutions (i.e. they are not formally part of the government), but they are under ministerial control in terms of the appointment of the management and supervision. The management board and director of the Central Agency for Financing and Contracting of the Programmes and Projects of the European Union are appointed by the Minister of Finance, and the same ministry supervises the work of the Agency. In the case of the Agency for Mobility and EU Programmes, the government appoints the management upon the proposal of the Minister of Science, Education and Sport, and its work is monitored by the Ministry for Education and the Ministry responsible for youth.

3.1.2 Parliamentary structures

The Standing Orders of the Croatian Parliament define the internal structure of the parliament. The standing working bodies of the parliament are committees and commissions. There are 22 Standing Committees and one Standing Commission.¹⁸⁹ The Provisions of the Standing Orders enable the establishment of new bodies, as the need arises.

The Croatian parliament participates in the preparations of the Republic of Croatia for the EU membership mainly through the European Integration Committee, the National Committee, as well as through the Croatia-EU Joint Parliamentary Committee.¹⁹⁰ Other committees (the Inter-parliamentary Cooperation Committee, the Foreign Affairs Committee) also deal with EU-related issues as the need arises.

The European Integration Committee was established in 2001 as a standing committee. It monitors alignment with the EU *acquis*, assistance programmes and programmes of cooperation with the European Union, as well as the implementation of the

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0679:FIN:EN:PDF>

¹⁸⁸ Croatian Parliament, “Regulation on establishment of the Central Agency for Financing and Contracting of the Programmes and Projects of the European Union,” *Official Gazette*, no. 90 (2007), <http://www.nn.hr/clanci/sluzbeno/2007/2734.htm>, and Croatian Parliament, “Law on the Agency for Mobility and EU programmes, Official Gazette,” no. 107 (2007), <http://www.nn.hr/clanci/sluzbeno/2007/3131.htm>.

¹⁸⁹ Croatian Parliament important Legislation, “Standing orders of the Croatian Parliament,” Croatian Parliament, Article 56, <http://www.sabor.hr/Default.aspx?art=2434>.

¹⁹⁰ “Odluka o imenovanju Izaslanstva Hrvatskoga sabora u Parlamentarni odbor za stabilizaciju i pridruživanje,” *Official Gazette*, no. 147 (2004), <http://www.nn.hr/clanci/sluzbeno/2004/2579.htm>.

international treaties related to the Council of Europe.¹⁹¹ The Committee also cooperates and exchanges experience with European institutions and bodies. The Committee has 13 members, among which one acts as chair, and one as vice-chair.

The National Committee was established in January 2005, following the adoption of a Declaration on the basic principles of the accession negotiations by the parliament. The National Committee is a parliamentary working body, established pursuant to Article 43 of the Standing Orders of the Croatian parliament for monitoring the accession negotiations of the Republic of Croatia to the European Union.¹⁹² The National Committee:

- supervises and evaluates the progress of the negotiations,
- gives opinions and guidelines on behalf of the Croatian parliament on the prepared negotiating positions,
- considers information on the process of negotiations,
- considers and gives its views on the forthcoming questions on the agenda,
- analyses and assesses the performance of the individual members of the negotiating team,
- holds regular consultations and exchanges information with the President of the Republic of Croatia, the Prime Minister and the Chair of the Croatian Parliament,
- holds regular consultations with the Head of the Delegation and the Chief Negotiator on the progress of the negotiations, on issues that arise during the negotiations and possible ways of closing the individual chapters,
- gives opinions, as required, on the harmonisation of the Croatian legislation with the EU regulations,
- reports on the work of the Committee to the Croatian parliament at least twice a year.

The National Committee consists of 15 members, of whom 6 are members from the parties in office, and 6 are members from the opposition parties. The Chairpersons of the Foreign Policy Committee, the Antiparliamentary Co-operation Committee and the European Integration Committee are members of the National Committee, irrespective of their party affiliation. There are four non-voting members of the Committee: one representative of the

¹⁹¹ Croatian Parliament, *Standing orders of the Croatian Parliament, Article 97*, <http://www.sabor.hr/Default.aspx?art=2434>.

¹⁹² Croatian Parliament, “Decision on the establishment of a national committee,” *Official Gazette*, no. 12 (2005), <http://www.mvpei.hr/zakoni/PDF/Odluka%20o%20osnivanju%20Nacionalnog%20odbora%20NN%2012-05%20ENG.pdf>.

Office of the President of the Republic, one representative of the academic community, one representative of employers' associations, and one representative of the trade unions.

The Foreign Affairs Committee deals with foreign policy issues and international relations. Its tasks and activities include cooperation with the committees of the parliaments of third countries, and it is the main working body in the procedure of the ratification of international treaties.

The Inter-Parliamentary Cooperation Committee, together with the Foreign Affairs Committee, supports the implementation of the foreign policy in the framework of inter-parliamentary cooperation with third countries and international organizations.

The Parliamentary Delegation to the Croatia-EU Joint Parliamentary Committee was established in October 2004. The Croatian parliament nominated 15 members and 12 substitutes of the Parliamentary Delegation for the Croatia-EU Joint Parliamentary Committee delegation for co-operation with the European Parliament. The Croatia-EU Joint Parliamentary Committee conducts political dialogue. In particular, the aim of the Joint Parliamentary Committee is to promote:

- -Croatia's full integration into the community of democratic nations and gradual rapprochement with the European Union;
- - an increasing convergence of the positions of the two sides on international issues, also through the exchange of information as appropriate, and, in particular, on those issues that are likely to have substantial effects on Croatia and the EU; and
- - regional co-operation and the development of good neighbourly relations; common views on security and stability in Europe, including co-operation in the areas covered by the Common Foreign and Security Policy of the European Union.¹⁹³

Other committees deal with EU-related issues as the need arises. For example, the European Integration Committee, the Foreign Affairs Committee, and the Committee for Agriculture and Forestry held a common session on the negotiations for Protocol 7 of the Stabilisation and Association Agreement, covering trade in agricultural products.

¹⁹³ Croatian Parliament, Croatian Parliament delegation, <http://www.sabor.hr/Default.aspx?sec=380>.

3.1.3 The development of the institutional setting

The structure of the ten governments since 1990 have been quite heterogeneous in terms of their size, the number of vice-presidents, and ministers without portfolio, as well as the structures of ministries and central offices.

Table 3.1 Milestones in the development of the structures dealing with EU affairs

Period	Structure	Note
1990-92	Office for Alignment with European Integration	Part of the government
1992-98	Ministry of Foreign Affairs	
1998-2000	Minister for European Integration	
	Office for European Integration	
	Coordination for European Integration	Consisted of the Council of Ministers and the Advisory Committee
2000-05	Ministry for European Integration	
Since 2000	European Integration Committee	
2004	Head of the state delegation and the secretary of the negotiating team is appointed	
Since 2005	National Committee is established	
2005	Structure for accession negotiations is established	
Since 2005	Ministry for Foreign Affairs and European Integration	
2006	Central Office for Development Strategy and Coordination of EU funds	Central government office, which took over the responsibility for the coordination and management of the EU pre-accession funds from the MFAEI

The first structures for European integration were established in the 1990s (See Table 1.1). Different governmental bodies have been in charge of European affairs since.

The first structure for European integration, the Office for Alignment with European Integration was established in 1990, as part of the government¹⁹⁴. It functioned until 1992, when it was absorbed by the Ministry of Foreign Affairs. In 1998, the first minister responsible for European Integration was appointed, who was also a vice-president of the government.¹⁹⁵ The Office for European Integration and Coordination for European

¹⁹⁴“Regulation on Office for alignment with the European integration,” *Official Gazette*, no. 55 (1990), <http://www.nn.hr/clanci/sluzbeno/1990/1072.htm>.

¹⁹⁵ “Decision on appointment of the Minister in the government of Croatia,” *Official Gazette*, no. 32 (1998), <http://www.nn.hr/clanci/sluzbeno/1998/0377.htm>.

Integration was also established in 1998.¹⁹⁶ The Office for European Integration was monitoring the process of European Integration, and it prepared expert assignments for the Minister of European Integration in the area of work of the Coordination for European Integration.

The Coordination for European Integration consisted of the Council of Ministers and the Advisory Committee. The prime minister was the president of the Council of Ministers, while five ministers (the Minister for European Integration, the Minister of Foreign Affairs, the Minister of Finance, the Minister of Economy, and the Minister of Justice) were members. The Advisory Committee consisted of all the ministers. The president of the Advisory Committee was the Minister for European Integration, and the members were the line ministers.¹⁹⁷ Following the elections in 2000, the structure of the government changed. After a short period, when the minister without portfolio was responsible for the EU relations, in February 2000, the Ministry for European Integration was established. It consisted of a Cabinet, a Secretariat, and a Directorate for legal alignment, a Directorate for coordinating programmes of assistance and cooperation with the EU and a Directorate for Economic Alignment.

The Secretariat of the Chief Negotiator for European Union was established in the Ministry in July 2001. In 2002, the Directorate for the strategy of integration was established.¹⁹⁸ In January 2005, the government delegated the negotiation on the accession to the EU to the State Delegation and nominated a head of delegation, deputies, a Chief Negotiator and a secretary of the negotiating team.¹⁹⁹

The Ministry for Foreign Affairs and European Integration was created by merging the Ministry of Foreign Affairs and the Ministry for European Integration in March 2005.²⁰⁰

¹⁹⁶ "Regulation on Office for European Integration," *Official Gazette*, no. 51 (1998), <http://www.nn.hr/clanci/sluzbeno/1998/0645.htm>.

¹⁹⁷ The Minister of Foreign Affairs, the Minister of Finance, the Minister of Science and Technology, the Minister for Development and Reconstruction, the Minister of Interior, the Minister of Economy, the Minister for Agriculture and Forestry, the Minister for Maritime Affairs, Transport and Communications, the Minister of Justice, the Minister for Administration, the Minister for Spatial Planning, Construction and Housing and the Minister of Labour and Social Care.

¹⁹⁸ "Uredba o izmjenama i dopunama Uredbe o unutarnjem ustrojstvu Ministarstva za europske integracije," *Official Gazette*, no. 69 (2002), <http://www.nn.hr/clanci/sluzbeno/2002/1163.htm>.

¹⁹⁹ Croatian Parliament, "Statement by the Croatian Parliament and the government of the Republic of Croatia on joint actions in the process of negotiations on membership of the European Union," *Official Gazette*, no. 12 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0189.htm> and "Odluka o imenovanju voditeljice i zamjenika voditeljice Državnog izaslanstva za pregovore o pristupanju Republike Hrvatske Europskoj uniji, te glavnog pregovarača," *Official Gazette*, no. 11 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0182.htm>.

²⁰⁰ "Zakon o izmjenama i dopunama Zakona o ustrojstvu i djelokrugu središnjih tijela državne uprave," *Official Gazette*, no. 22 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0388.htm>.

The structure for the accession negotiations was formally adopted a month later, in April 2005, by a governmental decision. In addition to the state delegation and the secretary of the negotiating team, who had already been appointed, a coordinating committee, a negotiation team, working groups and the office of the Chief Negotiator were established.

The problem of the overload of Ministry of Foreign Affairs and European Integration, indicated through the declining number of laws harmonised²⁰¹, was partially addressed by the reorganisation of the Ministry and transferring some of its task to the Central Office for Development Strategy. The Central Office for Development Strategy took over the responsibility for the coordination and management of the EU pre-accession funds in August 2006.

3.1.4 The political importance of managing EU relations

Integration towards the EU has been one of the strategic priorities of the government. However, the political importance of the state officials dealing with European issues is limited.

Apart from the very first minister for European Integration, Ljerka Mintas Hodak, who was also vice-president of the government, later ministers have not had a high political profile. In the period 2000-01, the minister was Ivan Jakovčić, who resigned when his party, the Istrian Democratic Alliance (the IDS), left the government. After his resignation in June 2001, the new minister, Neven Mimica, was appointed in September. His task was considered largely a technical one.²⁰²

During the term of the office of the last government, in 2004-07, the organisation of EU-relations was highly centralised. The structure was formally dominated by the Ministry of Foreign Affairs and European Integration. However, the Minister of Foreign Affairs, Kolinda Grabar Kitarović, had limited influence. She joined the presidency of the Croatian Democratic Union (the HDZ) only after she was appointed minister. Her role in the last election campaign and her position within the HDZ indicated that she was on the way out.

201 c.f. Tomislav Maršić, "Assessing the negotiation experience: quick accession or good representation?," in *Croatian accession to the European Union, the challenges of participation*, ed. Katarina Ott (Zagreb: Friedrich Ebert Stiftung, 2006), 29-56.

202 "Croatia's ultimate expert," *European Voice* 7, no. 4 (2001), <http://www.europeanvoice.com/archive/article.asp?id=12388>.

Consequently, the high centralisation of the procedural and political power on a limited number of persons strengthened the position of the prime minister.²⁰³

A new Minister of Foreign Affairs and European Integration, Gordan Jandroković, has been appointed in January 2008. It is too early to estimate his performance and influence. It can be stated, however, that he has a stronger position in the party in office (the HDZ) than his predecessor, Grabar Kitarović.

3.2 Political relations

3.2.1 Positions on EU relations

3.2.1.1 The governments' positions

Croatia had contractual relations with the EU before 1991 through the EU-Yugoslavia co-operation agreement, which was abolished when the former Yugoslav federation disintegrated. The official position of the Croatian governments since 1991 has always been pro-European. Nevertheless, because of the war imposed on Croatia from 1991 till 1995, and its consequences, which produced un-democratic trends, in the period 1995-99 Croatia suffered relative isolation from the EU countries and the international communities.

The EU briefly started negotiating a co-operation agreement with Croatia in 1995. However, the negotiations were suspended due to the military operation Storm in the occupied territories. In the period 1996-99, President Tudjman strongly opposed the EU's policy towards the region, the so-called regional approach. The regional approach was considered to be an association of the Western Balkans, and Tudjman claimed that Croatia belonged to Europe, as opposed to Western Balkans. Despite the fact that Croatia's progress in democratisation, respect of human rights, including minority rights and the rule of law was non-existent or limited,²⁰⁴ the official position was still proclaimed European and the improvement of the relations with the European Union was identified as a strategic priority. In 1999, the government made its first concrete steps in defining priorities for the future

²⁰³ Op. cit. Tomislav Maršić, "Assessing the negotiation experience: quick accession or good representation?," in *Croatian accession to the European Union, the challenges of participation*, ed. Katarina Ott (Zagreb: Friedrich Ebert Stiftung, 2006), 29-56.

²⁰⁴ C.f. European Commission, Operational conclusions : Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions in the Council Conclusions of 29 April 1997 Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania, COM (1998) 237 final (Brussels, 1998)
http://ec.europa.eu/enlargement/pdf/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/com_1998_0237_en.pdf.

integration activities by adopting an Action Plan for European Integration, which contained a Government Policy Statement, and political, economic and legal reports.

The parliamentary elections in January 2000 and the election of Stjepan Mesic as President of the Republic in February 2000 marked a turning point in the relations between the EU and Croatia, which was reflected in a rapid development of the country's relations with the European Union. In November 2000, the government adopted guidelines for conducting negotiations on a Stabilisation and Association Agreement. Since 2001, all governmental bodies, when submitting legislative proposals, have to accompany it with an explanatory note concerning alignment with the EU.²⁰⁵

In December 2002, the parliament asked the government to apply for EU membership; the government submitted the application in February 2003. The EU application was the last major international undertaking of the Račan government, which submitted a 7,000-page report in reply to the questionnaire by the European Commission. The cross-party consensus on the political goals of the EU membership was maintained after the change of the government following the November 2003 parliamentary elections.

Membership in the European Union and NATO, relations with neighbours, developing economic diplomacy, and changing Croatia's international image were the five priorities of the foreign policy of the government in the period 2003-07. The achievements in this period include the opening of accession negotiations and finalising the screening process. Integration into the EU has remained a priority of the new Sanader's government for the period 2008-11.

3.2.1.2 Parliament and opposition reactions

All major and relevant parties represented in the parliament have supported Croatia's integration in the EU. During the time of Croatia's relative isolation from the EU countries, it was the opposition who started establishing contacts with the EU. In February 1999, the leaders of six parliamentary opposition parties (which later formed the government in the period 2000-03) went to Brussels, lobbied for the PHARE programme to be opened and promoted cooperation between Croatia and the EU.²⁰⁶

²⁰⁵ Government of the Republic of Croatia, 19 July 2001, Decision on measures in the process of approximation of the legislation of the Republic of Croatia with the *acquis communautaire*.

²⁰⁶ e.g. Dean Sinovčić, "Hoće li oporbena šestorica u Bruxellesu odbaciti regionalni pristup Europske unije," *Vjesnik daily* (1999), <http://www.vjesnik.hr/html/1999/02/05/ntem.htm#BOOKMARK%200>.

In 2002, the parliament adopted a resolution on Croatia's accession to the European Union. The Resolution was supported by the vast majority of the parliamentary clubs.²⁰⁷ In the Resolution on the Accession, the Croatian Parliament affirmed that the membership of Croatia in the European Union was a strategic national objective, which would be fully and permanently supported by the parliament. The general consensus of all parliamentary political parties regarding membership in the European Union was confirmed in the Joint Statement of all Political Parties at the beginning of the negotiations between Croatia and the EU in December 2004. The European position of the whole political elite was again confirmed in January 2005 through the parliamentary Declaration on the fundamental principles of the negotiations²⁰⁸ and the Joint statement with the government on the negotiation process.

The Declaration on the fundamental principles of the negotiations stipulates the role of the parliament in the alignment process, the importance of the cooperation with the government, and it also identifies the need for constitutional change. The Joint statement of the parliament and the government stipulated the importance of an ongoing dialogue and concerted actions in the process of negotiating Croatia's full membership in the European Union.²⁰⁹

3.2.1.3 Public opinion polls and the reaction of the public

The Ministry for European Integration commissions semi-annual public opinion polls on the European Union in the Republic of Croatia since 2000. The aim of the polls is to monitor the public's attitude towards the European integration and sources of information they have about it. Croatia is also included in the Eurobarometer surveys from 2004.

The latest results of the Standard Eurobarometer (Spring 2007) show that the majority of European respondents (52 per cent) perceive the European Union positively, with only 15

²⁰⁷ Signatories to the resolutions are the Social Democratic Party (SDP) Group, the Croatian Peasant Party (HSS) Group, the Croatian People's Party (HNS), the Primorsko-goranska Party (PGS) and the Slavonko-baranjska Croatian Party (SBHS), the Libra Group, the Liberal Party Group, the National Minorities' Group, the Istrian Democratic Forum (IDS) Group, the Croatian Democratic Union (HDZ) Group, the Croatian Social Liberal Party (HSL) Group, the Croatian Party of Rights (HSP)-Croatian Christian Democratic Union (HKDU) Group, the Democratic Centre (DC) Group, the Croatian Block Group.

²⁰⁸ Croatian Parliament, "Declaration on the Fundamental Principles of Negotiations on Full Membership of the Republic of Croatia in the European Union," *Official Gazette*, no. 12 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0190.htm>

²⁰⁹ Croatian Parliament, "Statement by the Croatian Parliament and the government of the Republic of Croatia on joint actions in the process of negotiations on membership of the European Union," *Official Gazette*, no. 12 (2005), <http://www.nn.hr/clanci/sluzbeno/2005/0189.htm>

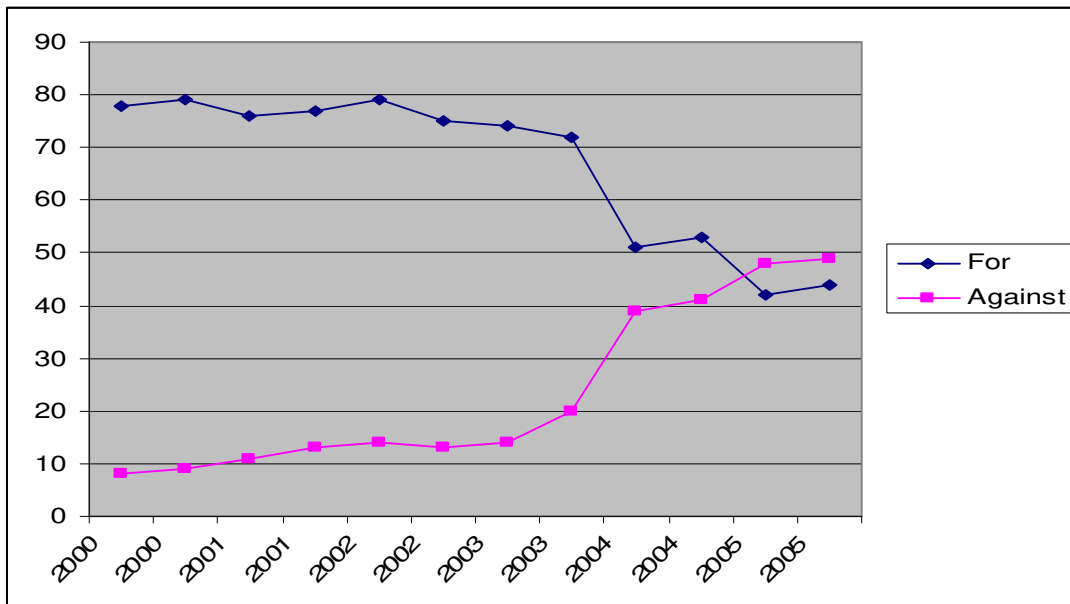
per cent perceiving it negatively. In Croatia, both groups represent 30 per cent, while a further 38 per cent are undecided. In 2006, the EU was positively perceived by 46 per cent and negatively by 17 per cent of the EU citizens. At that time, 33 per cent of the Croatian citizens had a positive attitude towards the EU, while 29 per cent had a negative one. Only 29 per cent of the Croatian citizens think that the EU membership would be good for Croatia, and those thinking it would be bad represent one percentage point less. 43 percent of the Croatian citizens expect benefits from the EU membership, but still five per cent more do not. Nevertheless, the majority of the Croatian citizens (49% vs. 43 %) would feel safer and think that Croatia would be economically (53% vs. 39%) and politically (45% vs. 35%) more stable if Croatia were a Member State.

Only a minority of the respondents in Croatia (35%) trust the European Union. While distrust in the EU is relatively stable, averaging 54% during 1995-2005, the unwillingness to join the EU was below 20% until the end of 2003. Since 2004, public opinion polls showed a change in the general attitudes of the Croatian citizens to the European Union. In 2004, unlike in previous rounds, more citizens (27.55%) showed a negative attitude towards the EU, while 43.4% of the citizens expressed a positive opinion about the Union.

Analyses show²¹⁰ that the motives of Euroscepticism seem to be heterogeneous, such as exclusive nationalism and its socio-cultural, political and economic premises, while the impact of utilitarian motives appear to be marginal.

²¹⁰ e.g. Aleksandar Štulhofer, "Euroscepticism in Croatia: on the far side of rationality?," in *Croatian Accession to the European Union, the Challenges of Participation*, ed. Katarina Ott (Zagreb: Institute of Public finances, 2006), 141-160. Dragan Bagić and Ante Šalinović, "Analysis of benefits and harms as a factor in citizen support to Croatian accession to the European Union," in *Croatian accession to the European Union, the Challenges of Participation*, ed. Katarina Ott (Zagreb: Institute of Public finances, 2006), 161-188.

Figure 3.1 The dynamic of the attitudes concerning accession to the European Union, Croatia 2000-05



Source: GfK- Croatia- omnibus, 2006, cited after Štulhofer, 2006, p. 146.

Public opinion polls in Croatia are consistent with the main characteristics seen in other Central and Eastern European countries: the further a country is from entering the EU, the smaller is the support for doing so.

3.2.2 Major events marking the EU-Croatia relations

Croatia declared its independence on 25 June 1991. The decision was suspended for three months, and it was confirmed on 8 October 1991 by the parliament's decision on the abrogation of the state-legal ties with the former SFRY. The EU recognised Croatia as a sovereign state in January 1992. In May 1992, the country was admitted to the United Nations.

Due to the war in the early 1990s and its political, economic and institutional consequences in the following years, Croatia lagged behind other Central and Eastern European Countries in its relationship with the EU²¹¹. In May 1992, the Commission presented a proposal to the Council for a Regulation to include Croatia in PHARE. At the

²¹¹ Katarina Ott, "Croatian accession to the European Union: the challenges of participation," in *Croatian accession to the European Union: the Challenges of participation*, ed. Katarina Ott (Zagreb: Institute of Public finances, 2006), 5.

time, the European Parliament rejected the proposal on the grounds of insufficient guarantees for the respect for human rights. The Council was of the same opinion. In 1995, the Commission proposed to extend the PHARE programme to include Croatia, but the negotiations of the cooperation agreement with Croatia and the application of the PHARE programme were suspended after the Croatian military actions in its occupied territory in 1995.

The General Affairs Council defined a regional approach, a policy that should foster the development of regional cooperation in the former Yugoslavia in 1996. The primary objectives of the EU Regional Approach were to reinforce the successful implementation of the Dayton/Paris and Erdut peace agreements, as well as to create an area of political stability and economic prosperity. The cornerstones of the approach were the promotion and maintenance of democracy, the rule of law, and the respect for human and minority rights, as well as the returning to economic growth. In 1999, the European Commission proposed the creation of the Stabilisation and Association Process, a more far-reaching strategy giving the countries in the region the prospect of increasing rapprochement with the EU, with the perspective of full integration into the European structures.²¹²

In May 2000, the Commission adopted a Feasibility Report proposing the opening of negotiations for a Stabilisation and Association Agreement (SAA). The Stabilisation and Association Agreement was signed in October 2001, and an Interim Agreement entered in force in March 2002. In 2003, the accession perspective of the Western Balkans countries, including Croatia, was confirmed. In April 2004, the European Commission issued a positive opinion on Croatia's application for EU membership. In June 2004, the European Council confirmed the status of candidate country for Croatia. In December 2004, the European Council set 17 March 2005 as the starting date for the negotiations, conditional upon full cooperation with the International Criminal Tribunal for former Yugoslavia (ICTY). The negotiation framework for Croatia was adopted on 16 March, but the start of the negotiations was postponed. On 3 October 2005, ICTY Chief Prosecutor found that Croatia was fully cooperating. Based on this opinion, the Council concluded that the last remaining condition for starting the negotiations was met. The accession negotiations were launched the same

²¹² European Commission, "Commission proposes a Stabilisation and Association process for countries of South-Eastern Europe," *Press Releases*, no. IP/99/350 (1999), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/99/350&format=HTML&aged=0&language=EN&guiLanguage=en>.

day, and the screening stage of the accession negotiations began in October 2005. Screening was concluded within a year.

Table 3.2 Major events marking the EU-Croatia relations

1992	The EU recognises Croatia as a sovereign state
1995	PHARE application and negotiations on a cooperation agreement suspended
1996, 14 February	The EU adopts a policy towards the Western Balkans; regional approach
1999, May	The European Commission proposes the Stabilisation and Association Process
2000, 15 February	The EU-Croatia Joint Consulting Task Force is set up
2000, 24 November	The beginning of the negotiations on the Stabilisation and Association Agreement (Zagreb Summit)
2001, 19 October	The Stabilisation and Association Agreement is signed
2002, 1 March	The Interim Agreement enters into force
2003, 21 February	Croatia applies for EU membership
2003, June	Confirmed accession perspective (Thessaloniki summit)
2004, 20 April	The EC issues a positive opinion on Croatia's application for membership
2004, 18 June	The European Council confirms Croatia as a candidate country
2004, 20 December	The European Council sets 17 March 2005 as the starting date for the negotiations (conditional)
2005, 1 February	The SAA enters into force
2005, 16 March	The EU accession negotiations are postponed, framework for negotiations is adopted
2005, 26 April	The first meeting of the Stabilisation and Association Council; the meeting of the extended EU Troika on Croatia's cooperation with the International Criminal Tribunal
2005, 3 October	Accession negotiations are launched
2005, 20 October	The beginning of the screening process
2006, 12 June 12	The opening and closing of the Science & Research chapter of the <i>Acquis communautaire</i>
2006, 18 October	Screening completed
2006, 11 December	The opening and closing of the Education & Culture chapter of the <i>Acquis</i>
2006, November	The EC publishes Enlargement Strategy 2007-2008
2007, 1 January	Croatia is included in the IPA
2007	Croatia opens 11 negotiations chapters
2007, 16 November	The EC publishes the Croatia Progress Report and Enlargement Strategy

3.2.2.1 High-level political contacts with the EU

The high-level political contacts with the EU can be divided into three large groups: political contacts in the period until 2000, the period between 2000-04, and the formalised political dialogue following the entry into force of the Stabilisation and Association Agreement.

Following the 2000 elections, on 15 February 2000, the EU-Croatia consultative task force was set up, and it adopted joint recommendations concerning the conditionality subjects (the rule of law, the return of refugees, cooperation with the ICTY, the democratisation of the media). In March 2000, Chris Patten, Commissioner for Foreign Affairs, visited Zagreb, while President Mesić, Minister for Foreign Affairs Tonino Picula, and Minister for European Integration Ivan Jakovčić visited Brussels in July 2000. That was the first official visit of President Mesić to the EU and NATO. In addition to Romano Prodi, the meeting included a meeting with high representative for CFSP Javier Solana, Commissioner for External Relations Chris Patten, and NATO general secretary George Robertson.²¹³ The initiative of French President Jacques Chirac to organise an EU-Western Balkans summit was discussed.

As a result of this initiative, the Zagreb Summit was organised in November 2000, jointly by the government of the Republic of Croatia and the French government, in its capacity as the EU presidency. The negotiations with the European Union on the Stabilisation and Association Agreement were also launched, which was a bold step towards one of the main goals of the Republic of Croatia – achieving membership in the European Union. President Mesić has remained active in the enhancement of the EU-relations. His latest activities (in December 2007) include a 3-day visit to Brussels including meetings with NATO general secretary Jaap de Hoop Scheffer, Hans-Gert Poettering, High representative for Foreign and Security Policy Javier Solana and Commissioner Olli Rehn.

3.2.2.2 Formal political dialogue

The entry into force of the Stabilisation and Association Agreement on 1 February 2005 marked a new stage of enhanced relations and cooperation between the EU and Croatia. A set of joint bodies was established at the ministerial level (the Stabilisation and Association Council), at the high officials' level (the Stabilisation and Association Committee), and at the technical level (Subcommittees).

²¹³ Croatian Television News, "Predsjednik Mesić doputovao u Bruxelles u posjet EU-u, NATO-u i Belgiji," <http://vijesti.hrt.hr/arhiv/2000/07/17/HRT0013.html>.

The first Stabilisation and Association Council meeting took place in Luxembourg on 26 April 2005. The President of the Council, Jean Asselborn, Deputy Prime Minister, Minister for Foreign Affairs and Immigration of Luxembourg, led the EU delegation. Javier Solana, High Representative/Secretary General, Olli Rehn, Commissioner for Enlargement and Ambassador Grant, UK permanent representative to the EU, also participated in the meeting as members of the Troika. The Minister of Foreign Affairs and European Integration, Kolinda Grabar-Kitarović led the delegation of the Republic of Croatia.²¹⁴ The second meeting of the SA Council was held on 10 April 2006, and the third on 6 March 2007.²¹⁵

The Stabilisation and Association Committee, established under the SAA to conduct political dialogues at senior officials level, meets, as the SAA Council, on an annual basis. The first Stabilisation and Association Committee took place in Brussels on 14 July 2005, the second was held in Zagreb in 2006, and the last, third meeting was held on December 5, 2007 in Brussels. Those took stock of the recent developments regarding the political and economic criteria, as well as Croatia's progress in aligning to the body of the Community law (the reform of the public administration, fight against corruption, as well as issues related to state aid and public procurement). The meeting was chaired by Christian Danielsson, acting Director in the European Commission Directorate General for Enlargement. Marija Pejčinović-Burić, State Secretary for European Integration in the Ministry of Foreign Affairs and European Integration of the Republic of Croatia headed the Croatian delegation.

The Joint Parliamentary Committee (JPC) meets every six months. The first meeting took place in Zagreb on 3-4 March 2004.

3.2.2.3 High-level political contacts with the Member States

Bilateral relations with the EU Member States have been steadily progressing since 2000. President Mesić decided that France should be the first country he would visit after he was elected Croatian President, as France was taking over the EU presidency. On his trip to France, the President was accompanied by Goranko Fižulić, Minister of Economy, Ivan Jakovčić, Minister for European Integration, and Deputy Foreign Minister Vesna Cvjetković-Kurelec. Defence Minister Alain Richard welcomed the President, followed by talks with French President Jacques Chirac, who said that Croatia could play a very important role in

²¹⁴ Council of the European Union, "EU-Croatia Stabilisation and Association Council." *Press Releases*, no. 8441/05 (2005), http://www.eu2005.lu/en/actualites/documents_travail/2005/04/26cro01/croa.pdf.

²¹⁵ Presidency of the European Union 2006, "EU-Croatia Stabilisation and Association Council," *Press Releases*, (2006), http://ue2006.at/en/News/Press_Releases/April/1004CroatiaSAC.html?month=4&day=1.

the region. During their talks, they covered all current issues: the problems of the region, the problems in the Croatian neighbouring countries, and finally, all the efforts Croatia was making in order to achieve democratic standards and its strategic objectives. Following the meeting with President Chirac, President Mesić talked with Raymond Forni in the French parliament, and with Prime Minister Lionel Jospin in the government.²¹⁶

A joint Croatian-Italian statement regarding the special relations between the two countries was signed in 2000 by Croatian Prime Minister Račan and Italian Prime Minister Giuliano Amato. Bilateral relations, specifically economic ones, were identified in the statements. It was also agreed to hold regular annual meetings at all levels. These meetings include joint consultations at a political and technical level. Special relations also relate to bilateral cooperation in the field of economy, trade, transport and tourism.

There have been no changes in the German foreign policy towards Croatia, no matter what party is in power. German President Schroeder was the first to invite Prime Minister Sanader to Germany after the Croatian Democratic Union (HDZ) won the 2003 elections. A number of visits followed, and the last visit of President Schroeder to Zagreb was in April 2007.²¹⁷

As listing all the high political contacts between Croatia and the EU Member States is beyond the scope of this paper, we illustrate them with the country's contacts with Greece and the UK.

3.2.2.4 Political relations visits with Greece:

- The President of the Hellenic Republic visited Croatia in May 2001, whilst President Mesić of Croatia paid an official visit to Athens from 18- 20 November 2003.
- On 9 June 2004, Deputy Foreign Minister Valinakis met with the Croatian Minister for European Integration, Kolinda Grabac-Kitarovic on the sidelines of the Wilton Park Ministerial meeting. The two sides exchanged views on Croatia's European prospects.

²¹⁶ "Posjet Predsjednika RH Francuskoj, Pariz, 11.-12. svibnja," *Bulletin of the Ministry for European Integration*, no. 11, (2000), http://www.mvpei.hr/ei/download/2002/08/28/May_June2000.pdf

²¹⁷ Government, "Zagreb-Berlin relations always excellent, say Sanader, Schroeder," *News*, (2007), http://www.vlada.hr/hr/naslovnica/novosti_i_najave/najave/2007/travanj/zagreb_berlin_relations_always_excellent_say_sanader_schroeder.

- The Greek Prime Minister met with his Croatian counterpart in Thessaloniki on 21 October 2004, on the occasion of the Congress of Orthodox Churches and the Congress of European Peoples Parties.
- At the United Nations General Assembly, Greek Foreign Minister Molyviatis met with the Croatian Foreign Minister.
- The Deputy Foreign Minister of Croatia, Biscevic, visited Athens on 3 February 2005 and met with Greek Deputy Foreign Minister Valinakis. Valinakis attended the swearing-in ceremony of President Mesic in Zagreb on 18th February 2005.²¹⁸

3.2.2.5 Political relations with the UK

- 18 July 2006 – Prime Minister Ivo Sanader met Prime Minister Tony Blair in London.
- 12 January 2006 – Chief Negotiator for the Accession of Croatia to the EU, Vladimir Drobnjak met the Minister for Europe, Douglas Alexander.
- 7-8 December 2005 - President Mesic attended a dinner organised by the East West Institute, at which Tony Blair was honoured with the “Statesman of the Decade” award, and met Deputy Prime Minister John Prescott.
- 29-30 November 2005 - President Mesic gave a lecture at the Oxford Union and met the Lord Mayor of London, the President of the European Bank of Reconstruction and Development (EBRD), and other business leaders.
- 27 October 2005 – Prime Minister Ivo Sanader visited the UK to attend the EU informal summit at Hampton Court Palace and met the Prime Minister.
- Deputy Prime Minister John Prescott visited Zagreb on 26 October 2005 and met President Mesic and Prime Minister Sanader.
- 20-21 October 2005 - Neven Ljubicic, Minister of Health, attended the informal Health Ministerial Conference in Chandler's Cross, Hertfordshire and met the Health Secretary, Patricia Hewitt.
- 9-12 September 2005 - Petar Cobankovic, Minister of Agriculture and Forestry, attended the Agriculture and Environment Informal Ministerial summit of the EU Agriculture and Environment Ministers in London and met the Environment Secretary, Margaret Beckett.

²¹⁸ Ministry of Foreign Affairs Greece in the World, Bilateral Relations between Greece and Croatia, Ministry of Foreign Affairs. <http://www.yplex.gov.gr/www.mfa.gr/en-US/Policy/Geographic+Regions/South-Eastern+Europe/Balkans/Bilateral+Relations/Croatia/>.

- 8-9 September 2005 - Vesna Skare Ozbolt, Minister of Justice, and Ivica Kirin, Minister of Interior, attended the Justice and Home Affairs Informal Ministerial summit of the EU Justice and Interior Ministers in Newcastle and met the Home Secretary, Charles Clarke.
- 1-2 September 2005 - Kolinda Grabar Kitarovic, Minister for European Integration, visited the UK for the Gymnich Informal Ministerial summit of the EU Foreign Ministers in Newport and met the Foreign Secretary.
- 10-14 July 2005 - A Parliamentary Delegation from Croatia visited the UK and met Douglas Alexander MP, Minister for Europe.
- 22-24 June 2005 - Filip Dragovic, Assistant Minister for European Integration and Peacekeeping Operations.
- 20-23 June 2004 – Vladimir Seks, Speaker of the Croatian Parliament, visited the UK on the invitation of the Rt Hon Michael Martin MP and met the Political Director, House of Lords committee members and Scottish parliament members.
- 7 June 2004 – Miomir Zuzul, Foreign Minister (HDZ), visited the UK and met with Denis MacShane MP, Minister for Europe.
- 10-12 May 2004 – Kolinda Grabar Kitarovic, Minister for European Integration, visited the UK and met Denis MacShane MP, Minister for Europe and Sir Stephen Wall. She also spoke at a Chatham House event on “Croatia and the EU in light of the European Commission's Opinion”.
- Minister for Europe MacShane visited Zagreb on 19-20 April 2004 and met President Mesic, Prime Minister Sanader, Foreign Minister Miomir Zuzul, and Minister for European Integration Kolinda Grabar-Kitarovic.
- 11 February 2004 – Miomir Zuzul, Foreign Minister (HDZ), visited the UK and met the Foreign Secretary, the Defence Secretary and Denis MacShane MP, Minister for Europe.²¹⁹

3.2.2.6 Diplomatic relations with EU

The EU Member States were the first ones with which Croatia established diplomatic relations. Diplomatic relations with Austria and Germany were established on 15 January

²¹⁹ Country profiles, “Country profile: Croatia,” Foreign and commonwealth office, <http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1007029394365&a=KCountryProfile&aid=1019233785159>.

1992, the day Croatia was recognised as a sovereign state. By the end of March 1992, Croatia established relations with Italy, Hungary, Denmark, Portugal, Liechtenstein, Slovenia, the Netherlands, Latvia, Finland, Estonia, Spain, Belgium, and Lithuania. Within a year, diplomatic relations were established with Poland, France, Luxemburg, the United Kingdom, Iceland, Malta, Greece, Bulgaria, and Romania. Within 2 years diplomatic relations were established with all present Member States, Cyprus being the last one on 4 February 1993.²²⁰

All but three (Estonia, Latvia, Lithuania) EU Member States have established an embassy in Zagreb. Some of them also have general consulates (e.g. Italy has consulates in Rijeka and Split), and honorary consulates (e.g. Austria in Dubrovnik, Pula, Rijeka and Dubrovnik). Croatia has diplomatic missions in 23 EU Member States (except in Malta, Estonia, Lithuania, and Latvia).

Diplomatic relations between Croatia and the EC were established in March 2000, when the EC Delegation replaced the former Office of the EC. Per Vinther, former Special Envoy of the EC, was appointed Head of the EC Delegation to the Republic of Croatia.²²¹

In 2001, the general representation of Croatia in the institutions of the European Communities and its Member States was established²²², and in 2002, a Permanent Mission of the Republic of Croatia was set up to the European Communities. The importance of the diplomatic relations with the EC was also demonstrated in 2001, when Per Vinther was decorated for fostering political dialogue between Croatia and the EC²²³. President Mesić also decorated Jacques Wunenburger, the next chief of the Delegation of the European Commission to Croatia, for his contribution to the institutionalisation of the relations between Croatia and the European Commission.²²⁴ President Stjepan Mesić also decorated Schroeder for his contribution to the promotion of bilateral relations and the support to Croatia in its Euro-Atlantic integration.²²⁵

²²⁰ Ministry of Foreign Affairs and European Integration of the Republic of Croatia.

²²¹ "Opening of the European Commission's Delegation in Zagreb, 9 March," *Bulletin of the Ministry for European Integration*, no. 19, (2000), http://www.mvpei.hr/ei/download/2002/08/28/March_April_2000.pdf.

²²² "Odluka o osnivanju Općeg predstavništva Republike Hrvatske pri institucijama i zemljama Europske zajednice," *Official Gazette*, no. 22 (1991), <http://www.nn.hr/clanci/sluzbeno/1991/0664.htm>.

²²³ "Decision on decoration of Per Vinther, Ambassador, Chief of the Mission of the European Commission to the Republic Croatia," *Official Gazette*, no. 83 (2001), <http://www.nn.hr/clanci/sluzbeno/2001/1419.htm>.

²²⁴ "Decision on decoration of Jacques Wunenburger, Chief of Delegation of the European Union to the Republic Croatia," *Official Gazette*, no. 84 (2005) <http://www.nn.hr/clanci/sluzbeno/2005/1615.htm>.

²²⁵ Government, "Zagreb-Berlin relations always excellent, say Sanader, Schroeder," *News*, (2007), http://www.vlada.hr/hr/naslovnica/novosti_i_najave/najave/2007/travanj/zagreb_berlin_relations_always_excellent_say_sanader_schroeder.

3.2.2.7 Parliamentary contacts

As with the governmental relations, parliamentary contacts have also intensified since 2000. Doris Pack, Head of the European Parliament Committee for Southeast Europe visited Zagreb on 17 March 2000.

The Stability Pact Parliamentary Summit held in September 2000 gathered delegations of 39 countries and six international organisations, i.e. parliamentary assemblies. Zlatko Tomčić, President of the Croatian National Parliament, hosted the meeting. Prime Minister Ivica Račan, Bodo Hombach, Special Co-ordinator of the Stability Pact, Adrian Severin, President of the Parliamentary Assembly of the OSCE, and Lord Russel Johnston, President of the Parliamentary Assembly of the Council of Europe, addressed the gathering. The main topics of the Zagreb Summit were expanding co-operation among countries, in particular among the Parliaments of the Pact participating countries, as well as how to increase the level of respect for human rights in the context of the Euro-Atlantic integration.²²⁶ Visits gradually intensified, and following the entry into force of the Stabilisation and Association Agreement, political dialogue was created in the framework of the Stabilisation and Association Parliamentary Committee.

Since Croatia became an EU candidate country in June 2004, Croatian parliamentarians have also been actively participating in inter-parliamentary activities in the framework of the European Parliament, the national parliaments of the EU Member States, and candidate countries. The most significant activities include the Conference of the Presidents of the Parliaments of the EU Member States, the Conference of the Community and European Affairs Committees of the Parliaments of the European Union, and the meetings of the chairpersons of the Foreign Affairs Committees of the EU Member States. The Joint Parliamentary Committee, established under the Stabilisation and Association Agreement, has had meetings every six months since March 2004.

3.2.2.8 NGO contacts

The strengthening of civil society and the reinforcement of the rule of law are crucial for building a functioning democracy. The EU has been providing support to NGOs that promote

²²⁶ “Stability Pact Parliamentary Summit, Zagreb, 11-13 September,” *Bulletin of the Ministry for European Integration*, no. 12, (2000), http://www.mvpei.hr/view1/download/2002/08/28/September_October_2000.pdf

democratisation since 1999, when the European Commission provided financial support to two Croatian NGOs (Glas and GONG) for election-related activities in the framework of the Programme for democratisation.²²⁷

One of the very first awareness-raising activities on the role of NGOs in the process of European integration was the international seminar “NGOs and public administration: perspectives of partnership in the Process of European Integration“, held in Zagreb in June 2001. The seminar brought together more than 120 participants, including Croatian NGOs, representatives of the EU institutions, European NGO networks and NGOs from the candidate countries.²²⁸ Later that same year (in October 2001) the founding of the National Foundation for Civil Society Development was initiated. In 2003, the Croatian parliament enacted the Law on the National Foundation for Civil Society Development. The Foundation invested significant effort in the establishment of relations with international partners.²²⁹

The European Economic and Social Committee (EESC) created the Western Balkans Contact Group in 2004, which participated in the preparation of an exploratory opinion requested by the European Commission on the situation of the civil society in the Western Balkans.²³⁰

The National Foundation and ECAS organised the international conference “The EU and Croatia: Strengthening Civil Society Dialogue” in Zagreb ²³¹ (on 30 September 2005). The conference raised the issue of the establishment of the EU-Croatia Civil Society Consultative Committee, just like in other candidate countries. On the basis of the conference conclusions and the foundation’s initiative, at the 78th session of the Economic and Social Committee held on 1 December 2005, the Council adopted a conclusion supporting the initiative to establish a joint consultative committee between the Republic of Croatia and the

²²⁷ The budget of the democratisation programme for NGOs in the field of democratisation, human and civil rights in 1999-2000 was 450,000 EUR , and the two Croatian projects received a support of EUR 45,000 each. Croatian television news, <http://vijesti.hrt.hr/arhiv/99/12/08/KRV.html>.

²²⁸ Igor Vidačak (ed.), *NGOs and Public Administration: Perspectives of Partnership in the Process of European Integration*, Zagreb, 2001.

²²⁹ The partners of the National Foundation are the government of the Republic of Croatia, the Delegation of the European Commission in the Republic of Croatia, the USAID -US Agency for International Development, the UNDP – United Nations Development Program, the Charles Stewart Mott Foundation, the National Foundation for Civil Society Development, Annual Report for 2004

²³⁰ European Economic and Social Committee, “EESC supports the development of social and civil dialogue in the Western Balkans,” *Press Release*, no. 31 (2006), http://www.eesc.europa.eu/activities/press/cp/docs/2006/cp_eesc_031_2006_en.doc

²³¹ “Civil society and EU. International Conference - EU and Croatia: Strengthening Civil Society Dialogue held in Zagreb,” National Foundation for Civil Society development, http://zaklada.civilnodrustvo.hr/index.php?d=165&p=eng_civilno_drustvo_i_eu&s=80

European Social and Economic Committee. The government of the Republic of Croatia forwarded to the Delegation of the European Commission to the Republic of Croatia and to the European Economic and Social Committee a request to establish a Joint Consultative Committee between the Republic of Croatia and the European Social and Economic Committee as soon as possible.

In October 2006, an agreement was reached between the EESC and Croatian civil society organizations to establish a joint body named EU-Croatia Civil Society Follow-up Committee. This Committee has the same goals as the similar joint advisory boards and committees established with the other EU candidate countries (i.e. Bulgaria, Romania, Turkey). The Follow-up Committee, with members from the EESC and the Croatian civil society, provides an opportunity to the civil sector to participate more actively in the Stabilization and Association Process, and it should contribute to Croatia's progress in the process of the EU accession.²³²

It is expected that the second Western Balkans Civil Society Forum, planned for 2008, will review the development of the situation in the region and the co-operation between the EESC and the Western Balkans civil society organisations.

3.2.3 Negotiations, EU-level agreement

3.2.3.1 Contractual relations

Croatia started negotiating a cooperation agreement in 1995, but negotiations were suspended.

Contractual relations began with the signature of the Stabilisation and Association Agreement (SAA) in 2001. The negotiations with the European Union on the Stabilisation and Association Agreement were opened on 24 November 2000 at the Zagreb Summit. The agreement was signed less than a year later, on 29 October 2001, and it entered into force on 1 February 2005. From January 2002, until the entry into force of the SAA, an Interim Agreement on trade and trade-related matters was applied.

Similarly to the Europe Agreements with previous candidate countries, the SAA provides the contractual framework for the relations between the EU and Croatia until the accession. It covers political dialogue, regional co-operation, the four freedoms, the creation

²³² OneWorld Southeast Europe, "EESC and Croatian CSOs Establish Joint Body," SEE Portal. <http://see.oneworld.net/article/view/140913/1/>

of a free trade area by 2007 for industrial products and most agricultural products, the approximation of the legislation of Croatia to the EU *acquis*, including precise rules in fields such as competition, intellectual property rights and public procurement, and wide-ranging co-operation in all the areas of EU policies, including in the area of justice, freedom and security. The full implementation of the SAA should help Croatia in its preparations for the EU membership. Conversely, progress as regards the EU integration will also be dependent on Croatia's fulfilment of its commitments under the SAA.

3.2.3.2 Negotiations with the EU

The European Council of June 2004 granted Croatia the status of candidate country. The negotiations with the EU cover 35 chapters of the *acquis*, 4 more than in the fifth enlargement. The most difficult chapters were divided into separate chapters for easier negotiation, and some easier chapters were united, moving some policies between chapters, as well as renaming a few of them in the process.

Table 3.3 Correspondence between the chapters of the 5th and the 6th Enlargement

5th Enlargement	6th Enlargement
1. Free movement of goods	1. Free movement of goods 7. Intellectual property law
2. Free movement of persons	2. Freedom of movement for workers 3. Right of establishment and freedom to provide services
3. Freedom to provide services	3. Right of establishment and freedom to provide services 9. Financial services
4. Free movement of capital	4. Free movement of capital
5. Company law	6. Company law
6. Competition policy	8. Competition policy 5. Public procurement
7. Agriculture	11. Agriculture and rural development 12. Food safety, veterinary and phytosanitary policy
8. Fisheries	13. Fisheries
9. Transport policy	14. Transport policy 21. Trans-European networks (one half of it)
10. Taxation	16. Taxation
11. Economic and Monetary Union	17. Economic and monetary policy
12. Statistics	18. Statistics
13. Social policy and employment	19. Social policy and employment (including anti-discrimination and equal opportunities for women and men)
14. Energy	15. Energy 21. Trans-European networks (one half of it)
15. Industrial policy	20. Enterprise and industrial policy
16. Small and medium-sized enterprises	
17. Science and research	25. Science and research

18. Education and training	26. Education and culture
19. Telecommunication and information technologies	10. Information society and media
20. Culture and audio-visual policy	
21. Regional policy and coordination of structural instruments	22. Regional policy and coordination of structural instruments
22. Environment	27. Environment
23. Consumer and health protection	28. Consumer and health protection
24. Cooperation in the field of Justice and Home Affairs	23. Judiciary and fundamental rights
	24. Justice, freedom and security
25. Customs union	29. Customs union
26. External relations	30. External relations
27. Common Foreign and Security Policy (CFSP)	31. Foreign, security and defence policy
28. Financial control	32. Financial control
29. Financial and budgetary provisions	33. Financial and budgetary provisions
30. Institutions	34. Institutions
31. Others	35. Other issues

Source: Acquis Communautaire, Wikipedia, http://en.wikipedia.org/wiki/Acquis#Chapters_of_the_Acquis

The accession negotiations with Croatia were opened in October 2005, with the screening stage. Following the conclusion of the screening process in October 2006, all 33 screening reports were submitted by the Commission to the Council. So far (as of January 2008), negotiations have been opened on sixteen chapters²³³ and provisionally closed on two (science and research, education and culture). On eleven chapters, opening benchmarks were agreed on by the Council and communicated to Croatia.²³⁴ In the Progress Report 2007, the Commission considered only the opening benchmark on justice, freedom and security to have

²³³ These are: science and research, education and culture, economic and monetary policy, industrial policy, customs, intellectual property rights, services, company law, statistics, financial services, financial control, information society and media, consumer and health protection, external relations, trans-European networks and financial and budgetary provisions.

²³⁴ I.e. public procurement; competition policy; justice, freedom and security; social policy/employment; capital; goods; agriculture; environment; food safety; regional policy, judiciary and fundamental rights

been met. The application of the Ecological and Fisheries Protection Zone to EU Member States, which started on 1 January 2008, slowed down the negotiations.

In January 2008, Austrian Socialist MEP Hannes Swoboda, who is in charge of the Croatian dossier in the European Parliament, called on the country to speed up its reforms in order to complete negotiations by 2009, or face delay in the EU membership. He also warned that if the Ecological and Fisheries Protection Zone was not solved, Slovenia, which currently holds the EU presidency, would not open the fisheries chapter of Croatia's negotiations package. In February 2008, Commissioner Olli Rehn indicated that 2008 can be a decisive year for Croatia's accession negotiations, if the country makes substantial progress in the judicial and administrative reforms, fighting corruption and restructuring the shipbuilding sector. He also indicated that Croatia needs to settle the Ecological and Fisheries Protection Zone issue and that the application of the Zone presents an obstacle for Croatia's accession negotiations.

The repeated warnings from the EU that the application of the Zone would have negative consequences for Croatia's ambitions to join the EU have led to a change in Croatia's position towards the Zone. Initially, the official position of the new Croatian government and President Mesic was that additional effort should be put on finding a suitable solution for all sides, but without questioning the Croatian legal right to regulate this issue in the first place. As the negotiations did not proceed after the Zone entered into force, the dilemma of either the EU or the Zone emerged. As the Prime Minister and the government believe that that priority should be given to the completion of the EU accession talks by mid-2009, the Croatian parliament gave up the full implementation of the Ecological and Fisheries Protection Zone in March 2008.²³⁵ The decision will remain in force until an agreement is reached in the European spirit.

Immediately after this decision, the Commission's President Barosso announced that Croatia should be able to conclude EU membership talks by the end of the mandate of the Commission (November 2009), provided a number of conditions are met by Croatia. He also announced that the 2008 Enlargement package (which is to be published in the autumn of 2008) will contain an indicative timetable for the technical conclusion of the negotiations in 2009.²³⁶

²³⁵ Croatian Parliament, 13 March 2008.

²³⁶ Speaking points of Commission President José Manuel Barroso, following his meeting with Croatian Prime Minister Ivo Sanader, available from http://www.vlada.hr/en/naslovnica/novosti_i_najave/2008/ozujak/predsjednik_vlade_s_predsjednikom_europske_komisije_barrosom, accessed on 1 April 2008

Table 3.4 The progress of the negotiations

<i>Acquis</i> chapter	Negotiation status	Alignment progress	Comments/benchmarks
1. Free Movement of Goods	Finished screenings	very hard to adopt	3 opening benchmarks defined
2. Freedom of Movement for Workers	Finished screening	very hard to adopt	EU's common position is being prepared
3. Right of Establishment & Freedom to provide Services	open chapter	very hard to adopt	6 closing benchmarks defined
4. Free Movement of Capital	Finished screening	Considerable efforts needed	2 opening benchmarks defined
5. Public Procurement	Finished screenings	very hard to adopt	2 opening benchmarks defined
6. Company Law	open chapter	Considerable efforts needed	4 closing benchmarks defined
7. Intellectual Property Law	open chapter		2 closing benchmarks defined
8. Competition Policy	finished screening	very hard to adopt	4 opening benchmarks defined
9. Financial Services	open chapter	very hard to adopt	5 closing benchmarks defined
10. Information Society & Media	open chapter	Considerable effort needed	3 closing benchmarks defined
11. Agriculture & Rural Development	finished screening	very hard to adopt	1 opening benchmark defined
12. Food safety, Veterinary & Phytosanitary Policy	finished screening	very hard to adopt	4 opening benchmarks defined
13. Fisheries	finished screening	Considerable effort needed	
14. Transport Policy	finished screening	Considerable effort needed	the EU is preparing its common position
15. Energy	finished screening	Considerable effort needed	the EU is preparing its common position
16. Taxation	finished screening	very hard to adopt	Croatia is preparing its negotiating position
17. Economic & Monetary Policy	open chapter		1 closing benchmark defined
18. Statistics	open chapter		2 closing benchmarks defined
19. Social Policy & Employment	finished screening	very hard to adopt	1 opening benchmark defined
20. Enterprise & Industrial Policy	open chapter		1 closing benchmark defined

21. Trans-European Networks	Open chapter		1 closing benchmark defined
22. Regional Policy & Coordination of Structural Instruments	finished screening	very hard to adopt	1 opening benchmark defined
23. Judiciary & Fundamental Rights	finished screening	very hard to adopt	3 opening benchmarks defined
24. Justice, Freedom & Security	finished screening	very hard to adopt	1 opening benchmark defined
25. Science & Research	Provisionally closed chapter		
26. Education & Culture	Provisionally closed chapter		
27. Environment	finished screening	situation totally incompatible with the EU <i>acquis</i>	1 opening benchmark defined
28. Consumer & Health Protection	open chapter	C	4 closing benchmarks defined
29. Customs Union	open chapter	C	3 closing benchmarks defined
30. External Relations	Open chapter	No major difficulties expected	1 closing benchmark defined
31. Foreign, Security & Defence Policy	Open chapter	No major difficulties expected	
32. Financial Control	open chapter	Considerable efforts needed	5 closing benchmarks defined
33. Financial & Budgetary Provisions	finished screening	No major difficulties expected	1 closing benchmark defined
34. Institutions	-	Non- <i>acquis</i> chapter, nothing to adopt	
35. Other Issues	-	Non- <i>acquis</i> chapter, nothing to adopt	

3.2.4 The positions of the EU Member States

The application of the EU conditionality differs among the EU member states. At the time of Croatia's application to the European Union, three EU countries were yet to ratify the Stabilization and Association Agreement: the United Kingdom, the Netherlands and Italy. In

2002, the United Kingdom and the Netherlands had halted the ratification process because of the Croatian government's handling of the Bobetko case²³⁷. Italy was rather slow because of issues relating to the bilateral property and minority rights (See more on this issue in Section 2.4.3). On the other hand, Austria strongly supported the opening of negotiations with Croatia in 2005.

As regards the neighbouring EU Member States, there are several issues to be fully resolved with Slovenia and Italy. Slovenia and Italy are both strongly opposing the application of the Ecological and Fisheries Protection Zone in the Adriatic, and there are also several problematic bilateral issues with these two countries.

3.2.4.1 The Ecological and Fisheries Protection Zone

Slovenia and Italy are disputing Croatia's decision to extend its territorial jurisdiction in the Adriatic Sea. In 2002, Croatia intended to proclaim its right to an exclusive economic zone (EEZ) in the Adriatic. Although Slovenia has only forty-seven kilometres of coastline, access to international waters has symbolic significance for the country, and thus, the decision by Croatia was met with a diplomatic offensive from Ljubljana, which raised the matter with EU officials and with member-state embassies and even briefly recalled its ambassador in Zagreb 'for consultations', only to send him back as a gesture of goodwill. Instead of an exclusive economic zone, the Croatian parliament proclaimed a somewhat ambiguous "Ecological and Fisheries Protection Zone". This policy has been in place since late 2004, but it excludes the EU countries (namely, Slovenia and Italy).

The Ecological and Fisheries Protection Zone was formally activated on 1 January 2008, which has raised the matter to the EU level. Slovenia, holding the EU presidency, required that Croatia immediately abolish the Zone. Despite the fact that the Ecological and Fisheries Protection Zone should apply to Croatia and the EU Member States equally, the Council called on Croatia not to apply any aspect of the Ecological and Fisheries Protection

²³⁷ In 2002, the International Criminal Tribunal for the Former Yugoslavia indicted general Bobetko, as the supreme commanding officer, for crimes against humanity and violations of the laws or customs of war during Operation Medak pocket in 1993. Bobetko refused to accept the indictment and surrender to the court, claiming that such an indictment questions the legitimacy of the whole military operation. The crisis stretched out, as popular opinion agreed with Bobetko, and the government was slow to reach a decision regarding his extradition. At that time, Bobetko was already gravely ill, and he died in 2003 before any final decision was reached regarding his extradition.

Zone to the EU Member States.²³⁸ Dimitrije Rupel, Slovenian Minister of Foreign Affairs indicated that the application of the Zone could block the accession negotiations with Croatia in 5-6 chapters.²³⁹ The European Parliament and the Council called on Croatia to suspend the application of the Zone, since it represented an obstacle for Croatia's accession negotiations.

The repeated warnings from the EU that the application of the Zone would have negative consequences for Croatia's ambitions to join the EU have led to a change of Croatia's position towards the Zone. Initially, the official position of the new Croatian government and President Mesic was that additional effort should be put into finding a suitable solution for all sides, but without questioning the Croatian legal right to regulate this issue in the first place. As the Prime Minister and the government consider that priority should be given to the completion of EU accession talks by mid-2009, the Croatian parliament gave up the full implementation of an Ecological and Fisheries Protection Zone in March 2008.²⁴⁰

3.2.4.2 Other open issues with Slovenia

In addition to the Ecological and Fisheries Protection Zone, which is currently (in January 2008) very high on the agenda, there are several additional issues that have yet to be fully resolved: border disagreement; property rights, and Croatian depositors' savings in Ljubljanska banka from the SFRY times.

Until 2001, the open issues with Slovenia (including borders, the savings in Ljubljanska banka, and NPP Krško) were considered as technical, negotiated by expert groups. As regards NPP Krško, the governments of Slovenia and Croatia appointed two expert groups to prepare a bilateral agreement on its status in 1998. Most of the issues were solved by an agreement ratified by both parliaments in 2002. The most challenging issue concerns the financial status of both parties, resulting from the period 1983-97, during which Slovenia did not provide electricity to Croatia from NPP Krško.²⁴¹

The border disputes include the maritime border in Piran Bay, a small number of pockets of land on the right-hand side of the river Dragonja in the Istria, the area around the

²³⁸ PRESS RELEASE, 2839th Council meeting, General Affairs and External Relations, GENERAL AFFAIRS, Brussels, 10 December 2007, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/gena/97555.pdf

²³⁹ Lada Stipić Niseteo, Voice of America, 11 December 2007

²⁴⁰ Croatian Parliament, 13 March 2008.

²⁴¹ Slovenian Presidency of the EU 2008. http://www.gov.si/ursjv/en/akt_dog/8_11.php

peak of the Žumberak/Gorjanci mountain, which is assigned partly to Slovenia (the Trdinov vrh area) and partly to Croatia (the Sveta Gera area). Despite the fact that the Croatian and Slovenian governments have reached a number of agreements, such as an understanding to avoid future incidents in the contested Bay of Piran, which was reached at a joint session on the Croatian island of Brijuni in early June 2005, a series of disputes could yet threaten Slovenia's support for Croatia's accession.²⁴² Croatian depositors' savings in Ljubljanska banka from the SFRY times is related to the loss of the savings deposited in the Zagreb branch of the former Ljubljanska bank.

3.2.4.3 Open issues with Italy

Croatia and Italy were debating bilateral property and ethnic minority rights issues stemming from border changes after World War II. At the moment, the key issue in bilateral relations, like with Slovenia, is the Ecological and Fisheries Protection Zone.

As regards bilateral property and minority rights, there were a number of Italian citizens who had been citizens of Yugoslavia before they were exiled shortly after World War II - known as the *esuli* (exiles) or *optanti* (volunteers). A later contract between SFR Yugoslavia and Italy prevented the restitution of their property, since a deal was made that made this seized property treated as war reparations. Still, there were people who were exiled during a period that was not covered by the aforementioned agreement, who demanded that their property be returned, and those who were exiled and wanted to buy real-estate in the same areas.

Neither of these groups was allowed to pursue these actions legally in Croatia, and so they were dissatisfied with the situation. The free acquisition of real estate by foreigners is a sensitive issue in Croatia. Numerous Italian politicians have expressed their discontent concerning the current inability of Italians to purchase land in Croatia, considering it discriminatory treatment, and stating that this issue should be resolved as soon as possible.

Croatia has denied discrimination, indicating that the Croatian legislation provides for the same treatment of all EU citizens concerning this issue. In mid-2006, Croatia and Italy reached an agreement, and now Italian citizens may purchase land in Croatia, and Croatian citizens may purchase land in Italy.

²⁴² Radio Free Europe, *Slovenia/Croatia: A New Dispute In Bilateral Relations?*, 20 July 2005. <http://www.rferl.org/featuresarticle/2005/07/f6443c62-4eb8-480a-8303-7ac8cad50696.html>

3.3 Economic relations

3.3.1 Trade regime

Croatia has been taking advantage of the autonomous trade preferences which the EU has been granting to it since 1993, on the basis of the earlier Trade and Economic Cooperation Agreement with the former Yugoslavia. These preferences belonged to the most favoured group and carried an exceptionally strong economic impact, enabling Croatian goods to be price-competitive on the EU market. However, without permanent institutional links, they could not warrant the long-term preferential treatment of Croatia by the European Union.²⁴³

Since November 2000, Croatia has benefited from the same regime granted unilaterally by the European Union to the countries of the Stabilisation and Association Process. In October 2001, the European Union and Croatia signed a Stabilization and Association Agreement (SAA). Related to the SAA, an Interim Agreement concerning trade and transport became effective on January 1, 2002. This agreement includes the Autonomous Trade Preferences that the EU previously extended to Croatia, providing all Croatian industrial and most agricultural products with free access to the EU market. On January 1, 2002, Croatia also started to gradually extend tariff preferences to the EU, providing free access to 70% of the value of the EU industrial and agricultural products exported to the Croatian market. Croatia's formal application for EU membership has been accepted, and Croatia is now working diligently on the accession negotiations (which started on October 4, 2005) and on adjusting its entire legislative and administrative system to the EU requirements.²⁴⁴

3.3.2 Foreign trade with the EU

3.3.2.1 The development of trade since 1990: Volume, dynamics, balance

The EU is Croatia's most important trade partner – 66% of the total foreign trade of the Republic of Croatia is with EU Member States²⁴⁵. During the transition period (1993-2001),

²⁴³ Višnja Samardžija, Mladen Staničić and Gorazd Nikić, ed., *Croatia and the EU: Costs and benefits of Integration* (Zagreb: IMO, 2000), 210.

²⁴⁴ Trade Regulations and Standards, "CCG - Trade Regulations, Customs and Standards," http://www.buyusa.gov/croatia/en/traderegulations.html#_section20

²⁴⁵ Based on data for 2006.

²⁴⁶ the share of the imports from Croatia in the total EU-15 imports fell from 0.4 to 0.2%. The value of exports to the EU rose by 13.6%, while that of the imports almost doubled, which led to a rise in the bilateral trade deficit.²⁴⁷ The share of imports from Croatia in the total EU-25 imports reached 0.4% in 2006.

Table 3.5 The developments of the Croatian exports and imports

	Total exports, million USD	Total imports, million USD	Total trade, million USD	Exports to the EU, million USD*	Imports from the EU, million USD*	Total trade with the EU; million USD*	Share of imports EU/total, %*	Share of exports/total, %	Share of trade, %
1992	4.6	4.5	9.1	2	1.8	3.8	40	43.5	41.8
1993	3.9	4.7	8.6	2.2	2.6	4.8	55.3	56.4	55.8
1994	4.3	5.2	9.5	2.5	3.1	5.6	59.6	58.1	58.9
1995	4.6	7.5	12.1	2.7	4.7	7.4	62.7	58.7	61.2
1996	4.5	7.8	12.3	2.6	4.6	7.2	59	57.8	58.5
1997	4.2	9.1	13.3	2.1	5.4	7.5	59.3	50	56.4
1998	4.5	8.4	12.9	2.2	4.9	7.1	58.3	48.9	55
1999	4.3	7.8	12.1	2.1	4.4	6.5	56.4	48.8	53.7
2000	4.6	7.8	12.4	2.2	4.4	6.6	56.4	47.8	53.2
2001	4.6	8.4	13	2.5	4.7	7.2	56	54.3	55.4
2002	4.9	10.7	15.6	3.2	7.6	10.8	71	65.3	69.2
2003	6.1	14.2	20.3	4.2	10.2	14.4	71.8	68.9	70.9
2004	8	16.6	24.6	5.2	11.5	16.7	69.3	65	67.9
2005	8.7	18.5	27.2	5.4	12.2	17.6	65.9	62.1	64.7
2006	10.3	21.5	31.8	6.6	14	20.6	65.1	64.1	64.8

*methodological note: the EU denotes EU-15 for 1992- 2001 and EU-25 from 2002

Source: Central Statistics Bureau

The rise of the EU's share after 2002 (from 55% to 69% in total trade, 56% to 71% in imports and 54 to 69% in exports) is the result of the change of the statistical set. The data from 2002 relate to the EU-25, while the earlier relate to the EU-15. As a share of the trade with the CEFTA members was roughly 14% in 2001, the enlargement reflected this change (See more detail in Section 3.1.3.)

²⁴⁶ As Croatia gained independence in 1992, here we present data from this year onwards. For more about the trade relations of Croatia in the late 1980s and the early 1990s, see Stjepan Zdunić, "Central Europe and Croatian foreign Trade Policy," *Croatian Economic Survey*, no. 2 (December 15, 1994), http://hrcak.srce.hr/index.php?show=toc&id_broj=651

²⁴⁷ However, some analyses show that trade links were not stopped but diverted, which is beyond the scope of this study.

Figure 3.2 The development of exports, imports and the trade balance

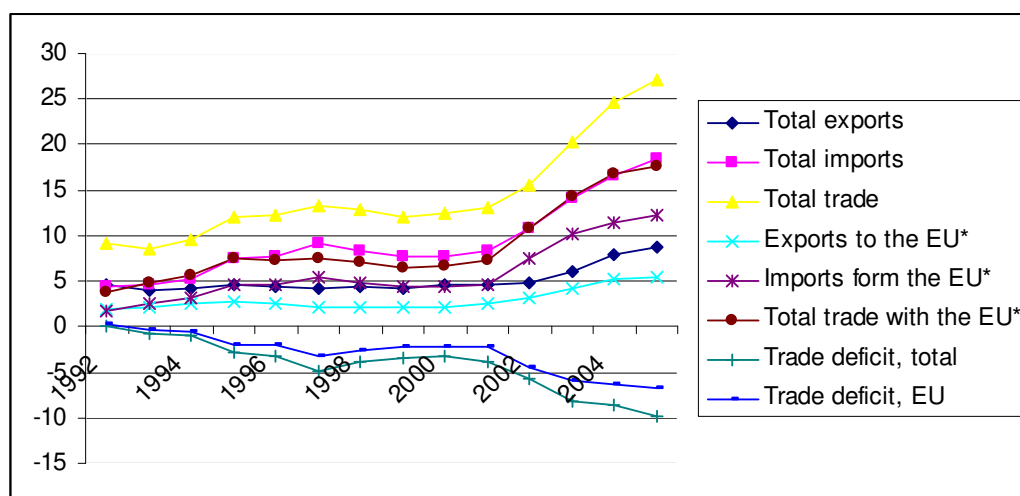


Table 3.6 The development of the trade balance, million USD

	Share of trade	Trade deficit, total	Trade deficit, EU
1992	41.8	0.1	0.2
1993	55.8	-0.8	-0.4
1994	58.9	-0.9	-0.6
1995	61.2	-2.9	-2
1996	58.5	-3.3	-2
1997	56.4	-4.9	-3.3
1998	55	-3.9	-2.7
1999	53.7	-3.5	-2.3
2000	53.2	-3.2	-2.2
2001	55.4	-3.8	-2.2
2002	69.2	-5.8	-4.4
2003	70.9	-8.1	-6
2004	67.9	-8.6	-6.3
2005	64.7	-9.8	-6.8
2006	64.8	-11.2	-7.4

Source: Central Statistic Bureau

During the transition period (1993-99), the share of Croatian products on the EU market was decreasing, while that of Central and Eastern European Countries (at the time applicants, now new Member States) mainly increased their shares on the EU market.

This may have reflected a slower pace in the restructuring of the Croatian economy as a whole, compared with other transition economies. The slow and inefficient restructuring have impeded the adaptation of the Croatian products to the demand in industrial countries, which has resulted in increasing the trade deficit. The relative trade deficit (41.5% in 2000)

was greater than in any of the candidate countries, and it was comparable with that in BiH and Albania.

In spite of the decrease and stagnation of the total exports to the EU and the decrease of the market share until 2001, the EU has remained the most important market for Croatian products. Until the fifth enlargement, roughly 50% of the total Croatian exports were to the EU, while the countries of South Eastern Europe absorbed 16.5 % of the Croatian exports and CEFTA states took 13%²⁴⁸.

Following the fifth enlargement, trade with the EU means trade with 25 countries instead of 15. For Croatia, the impact of the enlargement from EU-15 to EU-25 was an increase in the proportion of its trade with the EU from under 60 to over 70% of its total trade. The enlargement also caused a 10% increase of intra-EU trade and a 9% decrease of the extra-EU trade.²⁴⁹

3.3.2.2 Products and partners

The structure of the Croatian exports during the transition period remained unchanged. Sensitive sectors (agriculture, textile, footwear, iron and steel, wood) accounted for roughly 50% of the total exports to the EU. The main import products included vehicles (combined nomenclature, or CN code 87), boilers, machinery, reactors (84), electrical and electronic equipment (85), ships, boats and other floating structures (89), plastics and articles thereof (39), mineral fuels (27), paper and paperboard (48), articles of iron or steel (73), organic chemicals (29), pharmaceutical products (30).

The enlargement did not change the basic trade structure with the EU (the nature of the goods traded). The most important export products to the EU-15, identified at the level of the 98 products according to the two-digit combined nomenclature that denotes the statistical classification of the EU, were ships, clothing, electrical appliances and wood and wooden products. Exports were highly dependent on ten products categories, which accounted for around 70% of the total Croatian exports to the EU-15. The import structure was more

²⁴⁸ Ana-Maria Boromisa, "The First Round of Eastern Enlargement of the EU – Possible Implications for Croatian Trade" (paper presented at the Third Annual Conference of the European Trade Study Group, Brussels, Belgium, 2001), <http://www.imo.hr/europa/publics/euroreport/boromisa-paper.doc>

²⁴⁹ C.f. Ana-Maria Boromisa, "What does enlargement of the EU mean for Croatia," in *Croatian accession to the European Union, the challenges of negotiations*, ed. Katarina Ott (Zagreb: Institute for Public Finances : Friedrich Ebert Stiftung, 2005), 31-60, http://www.fes.hr/E-books/pdf/Croatian%20accession%20to%20EU_3td/02_0.pdf

diversified, and the 10 most important import products accounted for around 60% of the total imports.²⁵⁰

Following the enlargement, the export structure to the EU-25 has not changed significantly. The top ten export products according to the combined nomenclature have remained the same, but their ranking has changed slightly. Export specialization has decreased: instead of 71%, the top 10 products account for 67% of the total Croatian exports to the enlarged EU. The import structure has changed less since the enlargement: the top 10 products now account for 58% of the total imports, as compared to the previous 61% of total imports. The level of intra-industry trade between Croatia and EU has increased since the enlargement, which implies a higher level at which the membership criteria are being met. The main EU trading partners are Italy (20% of the total trade), Germany (15%), Slovenia (8%), Austria (7%), followed by France (4.5%) and Hungary (2.5).²⁵¹

3.3.3 FDI from the EU

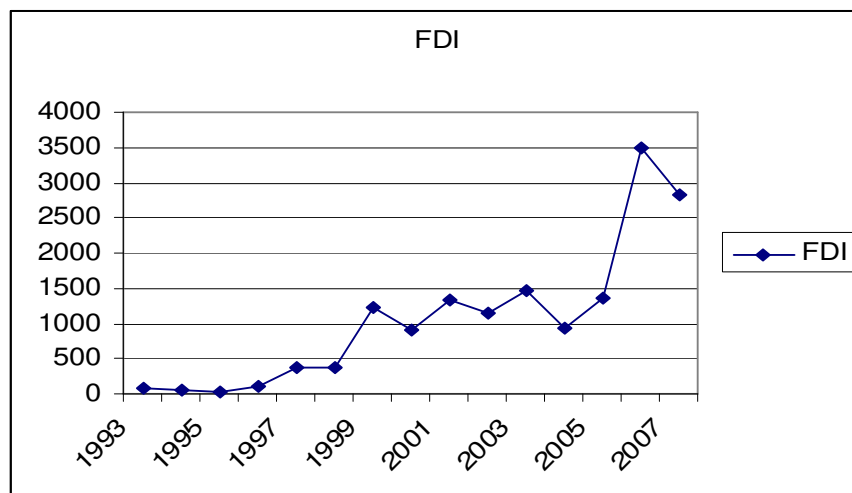
3.3.3.1 Foreign direct investments since 1990

The overall inflow of FDI in Croatia since mid-1990 until the end of 2006 reached EUR 14.2 billion or EUR 3,206 per capita. Croatia received EUR 2.8 billion during 2006. Some of the largest FDI transactions took place in the last quarter of 2006 (e.g. initial public offering regarding 15% of the stocks of the oil and gas company INA, the recapitalisation of foreign owned banks).

²⁵⁰ These products are: vehicles (CN 87), boilers, machinery, reactors (84), electrical and electronic equipment (85), ships, boats and other floating structures (89), plastics and articles thereof (39), mineral fuels (27), paper and paperboard (48), articles of iron or steel (73), organic chemicals (29), pharmaceutical products (30)

²⁵¹ Data for 2003. The shares and ranking of Italy, Germany, Slovenia and Austria have been relatively stable.

Figure 3.3 Foreign direct investments in Croatia from the EU Member States, 1993-2000, million EUR



Data source: Croatian National Bank

Table 3.7 FDI from the EU, million EUR, 1993-2007 (the first three quarters of 2007)

FDI, million EUR	
Austria	4,621.1
Netherlands	2,800.3
Germany	2,302.1
France	1,300.1
Hungary	1,008.0
Luxemburg	975.0
Italy	925.5
Slovenia	591.2
Belgium	406.8
UK	268.4
EBRD	257.4
Sweden	237.7
Denmark	84.3
Liechtenstein	68.4
Malta	67.0
Cyprus	55.8
Spain	43.9
Ireland	42.9
Slovakia	16.5
Czech Republic	15.0
Poland	11.2

Data source: Croatian National Bank

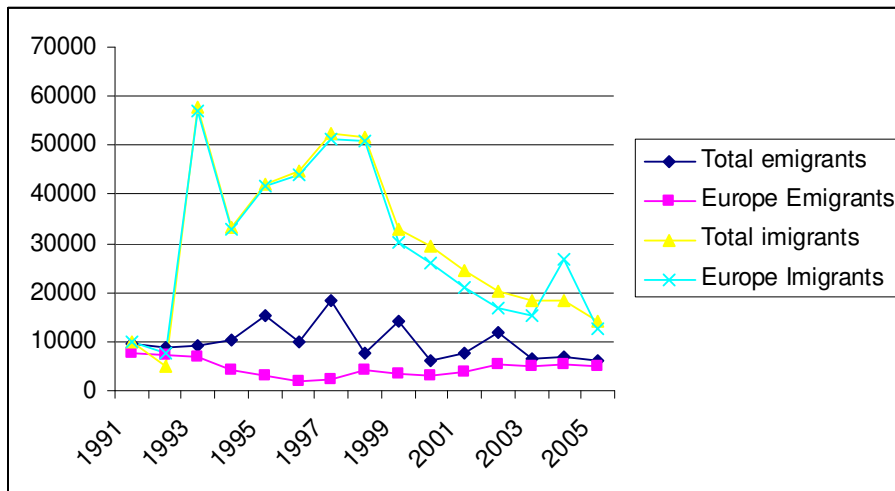
3.3.3.2 The main sectors and employment effects

Inflows have been concentrated in a few sectors. Just five industries have received more than 65% of the overall amount of FDI inflows: financial intermediation (31.1%), telecommunications (13.5%), chemical industry (14.0%), manufacture of coke and refined petroleum products (4.7%) and gas and wholesale trade (4.1%). The uneven flow of FDI and the dominance of brownfield investments underline the need for improvements in the business and investment climate, or generally the need for structural reforms, which will increase the competitiveness of the overall economy and its attractiveness for investors, in particular foreign investors.²⁵² The investments related to the restructuring of the industry, such as those in the telecommunication sector, were also connected with the loss of employment.

3.3.4 Labour migration to the EU since 1990

Despite the war and the transition, during the whole period since 1991, the number of emigrants was smaller than that of immigrants.

Figure 3.4 Immigrants and emigrants in the working age population in the period of 1991–2005



Note: Europe includes EU, EFTA and Western Balkans countries

²⁵² Central Office for Development Strategy and Coordination of EU funds, *Strategic Coherence Framework 2007-2013: Instrument for pre-accession assistance* (Zagreb: Central Office for Development Strategy and Coordination of EU funds, 2006), 16.

The main target country was Germany, which absorbed 50% of the migration to Europe (excluding ex-Yugoslavia) in the period of 1992-95. Austria (13%), Italy (3%), and Sweden followed²⁵³.

In the period 1996-2000, the total number of emigrants to Europe (excluding ex-Yugoslavia) decreased compared to 1991-95. In the period 1991-95 5,500 persons moved to Europe (excluding ex-Yugoslavia), and in the period 1996-2000, 50% fewer people did so (2,883). The main target country remained the same: Germany, Austria, Italy and Sweden, but their shares changed to 60%, 18%, 4.5% and 2.7%, respectively.²⁵⁴

During 2001-05, the level of emigration to Europe (excluding ex-Yugoslavia) remained stable, as did the shares of the main destination countries.

3.3.5 Infrastructure

Infrastructure development is of considerable significance for functioning energy and telecommunications markets, and a prerequisite for the implementation of the environmental policy. The alignment of policy instruments is a requirement for the EU integration, so infrastructure can be regarded as a means and a precondition for the integration into the EU.²⁵⁵

In Croatia, the infrastructure was seriously affected by war in the early 1990s. Direct war damage included the destruction of the infrastructure, which severely impeded road and rail traffic flow, inland navigation and energy supply. Significant indirect damage was also caused by under-investment, and decreased transport volume.

The estimated war damage in the infrastructure and telecommunications is presented in Table 3.8.

²⁵³ There was some more significant movement to Slovenia in 1991 and 1992, but Slovenia was not an EU member state then. However, we present here the movements to Austria and Sweden, who joined the EU in the mentioned period. Emigration to Sweden was at the level of Italy (3%).

²⁵⁴ Slovenia remained a significant target country. The migration to Slovenia was at the level of Austria. Source: authors' calculations based on the data of the State Bureau for Statistics.

²⁵⁵ C.f. Ana-Maria Boromisa, "Regional Cooperation, Coordination of National Policies and Alignment with the EU- the case of infrastructure," in *Completing Eastern Enlargement: Effects on the Accession of Croatia* (Zagreb, 2007), 53-65.

Table 3.8 War damage in the infrastructure and telecommunications

Type	Damage (USD)
Rail Transport	353,000,000
Road Transport	351,000,000
Sea Transport	38,000,000
Inland Waterways	90,000,000
Air Traffic	94,000,000
Telecommunications and TV	528,000,000
Energy Networks	680,000,000
Oil pipelines	24,100,000
Water Supply	196,980,000
Total	2,355,080,000

Source: *Procjena ratnih šteta u Hrvatskoj*²⁵⁶

The disruption in the main corridors has led to the diversion of traffic towards other, less common routes. The priorities have also changed for political reasons: in Croatia priority is given to V. pan-European corridor (north-east/south-west) instead of X. corridor (the former “trans-Yugoslav” north-west/south-east).

3.3.5.1 Transport ties with Croatia’s neighbours and the EU

Since the 1990s, the EU has gone through extensive planning, resulting in the trans-European transport networks (TEN-T). The World Bank’s analysis “The Road to Stability and Prosperity in South East Europe” from March 2000 increased awareness about the need to develop a regional medium-term approach to the transport infrastructure in the SEE.²⁵⁷ In addition, the “Western Balkan Transport Infrastructure Inventory“ financed by the EIB and presented in July 2000 provided a systematic inventory of the basic transport network elements in the region. This inventory was later used as a database for the development of the transport network planning projects. The Commission’s paper “Transport and Energy infrastructure in South East Europe” and the assessment of the needs for transport

²⁵⁶ (War damage estimate) for rail, road, sea transport, inland waterways and air traffic: Josip Kovačević et al., *Ratne štete i reparacije* (Zagreb: Školska knjiga, 1993), 100; for telecommunications and TV: Josip Božičević, *Ratna razaranja i štete u prometu i vezama Hrvatske* (Zagreb: HAZU, 1992); energy and oil networks: Ministry of Economy; water supply: Pavković, *Hrvatske ratne štete* (Zagreb, 1997), available from http://www.slobodanpraljak.com/materijali/PUBLIKACIJE%20O%20RATU/PROCJENA_RATNIH_STETA_U_HRVATSKOJ/PROCJENA_RATNIH_STETA_U_HRVATSKOJ.pdf

²⁵⁷ The World Bank, *The Road to Stability and Prosperity in South East Europe*, <http://www.seerecon.org/region/documents/wb/wbrs/index.html>

infrastructure (the Transport Infrastructure Needs Assessment - TINA) followed in 2001²⁵⁸, while the EIB developed a Medium-Term Strategy for the Western Balkans in June 2003²⁵⁹.

In 2004, a Memorandum of Understanding on the Development of the South East Europe Core Regional Transport Network (Core Network) was signed by Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro (including Kosovo), and the European Commission. The Memorandum of Understanding (MoU) provides for reciprocal consultations on transport policy and for the institutional reforms needed to make investments sustainable, and it opens the door to implementing a major infrastructure programme.

There is no regional structure for developing international transport. Based on the MoU, the South East Transport Observatory (SEETO) was established. The SEETO coordinates the development of the multi-annual plans for the development of the South East Europe core regional transport (See Tables 3.8 and 3.9.). The first five-year Plan for the Development of the Core Network was published in 2006²⁶⁰, and updates for 2007-11, 2008-12 are also available at the SEETO web pages.²⁶¹ The Core Network includes 4,300 km of railways across the five SEE countries, 6,000 km of roads, major ports and airports, and the inland waterways (the Danube and the Sava). The total cost of developing the Core Network has been estimated at over EUR 16 billion. 17 priority projects have been identified. Among these, three are in Croatia: (i) the rail track overhaul of the Savski Marof- Zagreb section, for which the terms of references are being prepared; (ii) the transport and trade integration at Port of Ploče and (iii) the construction of international passenger terminal at the Port of Dubrovnik. For both sea port projects, pre-feasibility studies are completed.²⁶² Other projects

²⁵⁸ European Commission, *Transport and Energy Infrastructure In South East Europe* (Brussels, 2001). http://www.seerecon.org/infrastructure/documents/ec_transport_energy_infrastructure_see.pdf

²⁵⁹ EIB, *Medium-Term Strategy for the Western Balkans*, http://www.eib.org/lending/balkan/docs/balkan_strategy_en.pdf

²⁶⁰ SEETO, *South East Europe Core Regional Network Development Plan, Five Year Multi-annual Plan 2006 to 2010*, <http://www.seerecon.org/infrastructure/sectors/transport/documents/Seeto%20final%20unutra%201.pdf>

²⁶¹ SEETO, *South-East Europe Transport Observatory*, <http://www.seetoint.org/site/documents.php>

²⁶² Other projects included in the plan are: the electrification of the railway section Beli Manastir–Vrpolje, the track overhaul of the railway section Križevci-Botovo DG, the railway track overhaul of the railway section Zagreb–Oštarije, the construction of a second rail track on 36 kms of the Dugo Selo-Križevci section, the modification of the electrical traction system on the rail line Moravice-Rijeka-Sapjane (Skriljevo-Bakar), track reconstruction on the Kosovo (Knin)-Split section, the reconstruction of the stations on the rail line Oštarije-Knin–Split, the construction of a second rail track on the Hrvatski Leskovac-Karlovac section, the railway rail track overhaul of the Oštarije-Ogulin (6.2 km) and the Skriljevo-Rijeka (11.4 km) sections, the rail track overhaul of the Skrad-Drivenik (37.15 km) section, the construction of a second track on the section Zagreb-V.Gorica, the remote rail control traffic system Savski Marof-Zagreb-Tovarnik, the rail track overhaul on the Vinkovci-Tovarnik section; the project of optical telecommunication rail network (the whole core HŽ network);

included in the Plan for the Development of the Core Network in Croatia include the modernisation of airports, roads, railways and sea ports.

Figure 3.5 The Southeast Europe core rail and ports network



Source: MoU, 2001, Annex 1, available from http://ec.europa.eu/ten/infrastructure/doc/2004_06_11_memorandum_annexe_1_a.pdf

the construction of the final phase of the container terminal Brajdica at the port of Rijeka; the construction of the passenger terminal - domestic transport, the development of the operative coast Kantafig, the expansion of the operative coast Gruž for the port of Dubrovnik. For more, see SEETO, *South-East Europe Transport Observatory: List of Projects for Country*, <http://www.seetoint.org/HRV/ProjectList.html>

Figure 3.6 The Southeast Europe core road and airport network



Source: http://ec.europa.eu/ten/infrastructure/doc/2004_06_11_memorandum_annexe_1_b.pdf

3.3.5.2 Telecommunication ties with Croatia’s neighbours and the EU

Compared with the other countries in the SEE, the Croatian telecommunications sector is very well developed.²⁶³ The improvement of the telecommunication network is included in the South East Europe Core Regional Network Development Plan, as a project of the optical telecommunication rail network (the whole core Croatian Railways network). The project has started, and upon its completion, the optical telecommunication network will cover the rail network and its interconnections with the neighbouring states.

In addition, it should be noted that Croatia follows and participates in some of the EU initiatives for an information society. There is a special central government office for e-Croatia (The Central Office for e-Croatia) that participates in the implementation of the

²⁶³ Cullen International. *Report 4 – Country Comparative Report: Supply of services in monitoring of South East Europe – telecommunications* (2007) http://ec.europa.eu/information_society/activities/internationalrel/docs/eu_enlargement/cullen_report4_comparative_final_nov_2007.pdf

eEurope Action Plan (the COBRA recommendations) and in the preparation of the i2010 initiative. The Croatian government adopted the Strategy for the Development of Broadband Internet access until 2008, and the Action Plan for the Implementation of the Strategy for 2007.²⁶⁴ The Strategy aims at a 12-percent coverage of broadband access by the end of 2008. This is in line with the EU objectives for broadband developments. Croatia also participated in the Stability Pacts' Initiative for Electronic South East Europe, which promoted sustainable investments in the ICT infrastructure. It is expected that some of these activities will continue under the Regional Cooperation Council and the signed Memorandum of Understanding on the development of a unified market of broadband networks that is fully interconnected with the European and global networks. By signing this MoU, Croatia joined the Initiative for Broadband South Eastern Europe, the BSEE.²⁶⁵ This should help improve connections with the SEE countries, since the internet infrastructure is better connected with Slovenia than with other countries.

Figure 3.7 The internet infrastructure in Croatia

Source: https://www.fer.hr/_download/repository/isp.pdf

²⁶⁴ Strategy can be downloaded from <http://www.e-hrvatska.hr>

²⁶⁵ Memorandum of understanding, <http://www.stabilitypact.org/e-see/bSEE%20MoU.pdf>

3.3.5.3 Energy supply and EU relations

The Croatian electricity network (See Table 3.10) was part of the former Yugoslav network. The war caused difficulties in supply: the lines in the occupied territories could not be used²⁶⁶, some of the power plants were damaged, and there was no supply from Serbia and Bosnia and Herzegovina. The construction of an interconnection line with Hungary stabilised the system, and the conditions for import/export and the transit of electricity were created.²⁶⁷

Against this background, it is not surprising that Croatia was slow to join the first Memorandum of Understanding on the Regional Electricity Market in South East Europe and its Integration into the European Union Internal Electricity Market in 2002. The signing of the MoU launched the Athens Process, a key element of the long-term strategy for energy in South East Europe. The Strategy was developed by the European Commission, together with the partner countries and with help from the international financial institutions (notably the EIB, the EBRD and the World Bank) in 2001, and it was endorsed in the framework of the Stability Pact. The aims of the Strategy relate to the energy infrastructure and market. The development of the energy infrastructure and the interconnections of regional interest should be, according to the Strategy, accompanied with the creation of a regional energy market. By signing the first MoU, the countries of the region committed to implementing parallel rules to the Community provisions, creating an internal electricity market.

Faced with the strong conditionality from the EU, Croatia committed to the first Athens memorandum in February 2003. The continuity stipulated by the EU concerned Croatia's commitment to regional co-operation within the framework of the Stabilisation and Association Agreement (SAA). The SAA explicitly secures the tightening of the cooperation in the adoption and planning of the energy policy, including the modernisation of the infrastructure, the security of the supply, and the reinforcement of efficiency. The accomplishment of this cooperation in the Athens process was seen as one of the elements to meet the regional cooperation obligation, which Croatia has bound itself to in the SAA as a precondition for further rapprochement with the EU and the acceptance of the EU demands, thus making the fulfilment of the membership conditions possible. The European

²⁶⁶ 380 kV line Obrovac- Meilne and 220 kV line Konjsko-Brinje. As a result, Southern Croatia was supplied through Bosnia and Herzegovina until September 1991, when the substation Ernestinovo was destroyed. Until December 2005, Dalmatia was supplied by diesel and gas power plants (175.8 MW installed at 11 locations). "Strategija energetskeg razvitka," *Official Gazette*, no. 38 (2002), <http://www.nn.hr/clanci/sluzbeno/2002/0839.htm>

²⁶⁷ 400 kV interconnection line Tumbri (Croatia) – Heviz (Hungary)

Commission in its SAA Implementation Report (2002) identified that Croatia had a potentially key role in the energy linkage of the region, particularly from the point of view of the development of the regional energy links (the physical infrastructure and the market).

Figure 3.8 The electric network of the Republic of Croatia, 2005, including interconnections



Source: *Energy in Croatia 2005. Ministry of economy, labour and entrepreneurship. P. 158, available also form <http://www.hep.hr/ops/hees/shema.aspx>*

In October 2004, Croatia had a key role in the physical reconnection of Zones I and II of the Union for the Co-ordination of Transmission for Electricity (UCTE). These had been operating as separate interconnected systems since 1991, when a large power substation at Ernestinovo in Eastern Croatia was destroyed in the war. The resynchronisation enabled the physical connection of the grids of South East Europe, including Greece, with the system of

Western Europe. It was the first step in the creation of an integrated energy market between the SEE and EU, and it was recognised as such in the Commission's 2005 Croatia Progress Report. The Report identified that Croatia has played an active role in the Energy Community Treaty process. The Croatian Minister of Economy presented the same view at the first Ministerial Conference of the Energy Community in Skopje, on 17 November 2006.²⁶⁸

It is the official position that on the entering into force of the Treaty establishing the Energy Community, Croatia becomes an integral part of the EU internal energy market on an equal footing. The fact that the accession to the Energy Community is also an important condition which the countries aspiring to become EU Member States need to fulfil is often underlined by the opposition, but not so clearly by the government.

3.3.5.4 Environment protection in Croatia

Croatia adopted the first environmental regulations in the first half of the 1990s. Significant progress has been achieved since then in institutional and legislative terms. Since 1997, new laws are gradually being aligned with the EU *acquis*. In 2000, the Ministry for Environmental Protection and Spatial Planning was established, replacing the State Administration for Environment. In 2002, the National Environmental Strategy and the National Environmental Action Plan were adopted. The Environmental Agency was established in 2002, and the Energy Efficiency and Environmental Fund was set up in 2003.

The process of integration towards the EU further increased the importance of the environment in domestic policies and also in its relations in the region and with the EU. The screening report published in February 2007 recognises the environmental chapter as very difficult, primarily due to the legislation that needs to be changed and the price tag attached to the implementation. A benchmark for opening the negotiations in the environmental chapter was defined: before the opening negotiations, Croatia has to improve the administrative capacity at the national, regional and local levels and develop an action plan identifying the time frame and (human and financial resources) to implement and enforce the *acquis*.

²⁶⁸ Report of the Ministry of Economy, www.mingo.hr

According to official estimates, Croatia will be able to meet the EU standards by 2015, provided that EUR 11 billion is invested in environmental protection.²⁶⁹ According to the National Environmental Action Plan (NEAP), the total costs of environmental infrastructure projects is estimated at about EUR 6,000 billion for the 10-year program.

Environmental protection is crucial for the sustainable development of South East Europe. As a part of the common objective of the SEE countries to gradually integrate into the European Union, they have committed themselves to compliance with the EU environmental laws, standards and policies. The SEE countries share similar problems in the area of environment. Also, there are potentially large cross-border externalities arising from the fact that interventions in the environment can have effects well beyond the boundaries of the country in which they are being undertaken. The international community and the SEE countries alike have increasingly recognized that the common problems and their trans-boundary effects can be tackled by a coherent regional approach to the environment, allowing for coordinated action in more than one country. A coherent approach can increase the benefits and reduce the costs of the environmental programs.

To enhance the cooperation between the countries and the international community in the field of the environment, a number of regional initiatives have been established. Croatia participates in the Regional Environmental Reconstruction Program for South-East Europe (REReP); the DABLAS Sava River Basin Initiative, and the Mediterranean Action Plan. The

²⁶⁹ Statement by N. Ružinski, negotiator for the Energy and Environment chapters, 6.4.2007, cited according to Croatian news agency HINA, available from <http://www.eu-pregovori.hr/default.asp?ru=542&gl=200704100000001&sid=&jezik=1>.

However, research and the evaluation of the expenses related to environmental protection in Croatia estimate the necessary amounts differently, but without a clear separation of the EU-related costs (e.g. the specific issues related to the implementation of the directives) and the non-EU related environmental costs (e.g. for infrastructure). The National Environmental Action Plan estimates the total costs of the environmental infrastructure for the 10-year program at EUR 6,000 billion. A number of sector-specific strategic documents and plans for air, waste and waters have been elaborated since 2002. These plans identify the necessary investments and financial means for environmental protection. In comparison with the NEAP, these documents cover a longer period of investment (approx. 20-25 years) for the individual segments. The draft Air Sector Implementation Plan covers an 11-year period from 2006-2016. The estimated capital investment costs of EUR 1,799 billion include the cost of improving the ambient air quality monitoring; bringing non-compliant large combustion plants into compliance with the directives; controlling VOC emissions from petrol storage and distribution installations; controlling VOC emissions from solvent-using applications; and modifications to refineries. The Waste Management Plan covers an eight-year period between 2007-2015. The estimated capital investment costs of EUR 350-400 million cover the cost of upgrading/establishing landfills for the disposal of municipal solid waste and non-hazardous industrial waste, the collection and recycling facilities for particular waste streams, and for the collection, storage and disposal of hazardous waste, including incineration. According to the Water Management Strategy (draft), the total capital expenditure in the water sector (2005-2020) is estimated to be EUR 3,700 billion. For more, see Sanja Tišma and Kristina Ozimec, "Environmental Protection in Croatia", in *FORUM-Scientiae et sapientiae* (2007), 38-43.

REReP and the Sava River Basin are initiatives under the Stability Pact for South Eastern Europe. They bring together countries in Central, Eastern and South East Europe with the International Financial Institutions (the EBRD, the EIB, and the World Bank), the European Commission, interested EU Member States, and other bilateral donors.

The **REReP** aims to foster regional environmental cooperation in South East Europe and to create conditions for sustainable environmental protection. It is focused on four principal themes: (i) institution building; (ii) support to the environmental civil society; (iii) support to environmental, regional cooperation mechanisms and cross-border projects; and (iv) reducing environmental health threats and the loss of biodiversity. The REReP has helped to develop and facilitate the implementation of a list of priority environmental investment programs covering the SEE countries. These priority projects focus on air pollution control and monitoring, efficient energy use and conservation, solid waste management, and water and wastewater management systems in the so-called hot spot locations. Key results of the REReP include:

- The development of a Balkan Environmental Enforcement and Compliance Network (BERCEN), which is designed in the long-term to become a parallel network to the EU's network for the Implementation and Enforcement of Environmental Law (IMPEL)
- A Regional Environmental Investment Strategy approved by all SEE countries
- Participation in the activities of the European Environmental Agency
- The signature of a series of bilateral Memoranda of Understanding on cross-border environmental cooperation
- The establishment of a network of South East Europe NGOs and raising awareness on regional environmental issues
- The creation of an online database (at <http://www.rec.org/REC/Databases/REReP/>) containing the details of the REReP projects (38 in Croatia)
- Setting up an informal donor network enabling an overview of the bilateral projects

The Sava River Basin Initiative has led to the creation of an international framework agreement for the Sava River and the establishment of the International Sava River Basin Commission with a seat in Zagreb. The Commission is responsible for the implementation of the agreement between Bosnia and Herzegovina, Croatia, Slovenia and Serbia. The Commission should contribute to (i) the rehabilitation and development of the navigation of the Sava basin and its main tributaries, the Drina and the Una (ii) ensuring the sustainable

development, utilization, preservation and management of the Sava basin water and related resources (iii) the preserving and protection of the environment, biodiversity and aquatic conditions of the Sava basin and (iv) the promotion of the social and economic welfare of the Sava basin riparian states and communities and the well-being of all the Sava basin riparian people.

The DABLAS Task Force brings together the Black Sea and Danube countries with the International Commission for the Protection of the Danube River (ICPDR), the Black Sea Commission, the IFIs (the EBRD, the EIB, and the World Bank), the European Commission, the Stability Pact, interested EU Member States and other bilateral donors to facilitate communication and coordination, which should result in a more focused approach to the protection of water²⁷⁰. The DG Environment of the European Commission holds the secretariat of the Task Force. The majority of the proposed projects listed in the DABLAS project pipeline target waste water treatment plants. The key outputs of the DABLAS include the drawing up of a short list of priority projects (out of which two are in Croatia) and the preparation of the prioritization criteria.

The Mediterranean Action Plan (MAP) strives to protect the environment and to foster sustainable development in the Mediterranean basin. It has been signed by 16 Mediterranean states and the EC, under the auspices of the United Nations Environment Program (UNEP). Its legal framework comprises the Barcelona Convention, adopted in 1976 and revised in 1995, and six protocols covering specific aspects of environmental protection. Within the framework of the MAP, several programmes have been developed, including the Global Environment Facility (GEF) Strategic Partnership on the Mediterranean, the Partnership for the Adriatic, and the Adriatic-Ionian initiative.

3.3.6 EU Pre-accession Funds

3.3.6.1 Forms of EU assistance since 1990

In the difficult period of war and transition, between 1991-95 the Community provided humanitarian assistance to Croatia. Since 1996, the assistance gradually developed into reconstruction assistance and support for refugee return. The EU consolidated its assistance in 2000 within the framework of the Stabilisation and Association Process. Since gaining candidate status in 2004, the assistance to Croatia has been increasingly integration-related.

²⁷⁰ More information is available at http://www.europa.eu.int/comm/environment/enlarg/dablas_en.htm

Between 1991 and 1995, the EC provided EUR 243.2 million for **humanitarian and relief assistance**. In the period 1996-2000, the assistance was focused on **reconstruction and support for refugee** return under the programme OBNOVA. Support was also given for democratisation, the independent media and de-mining. OBNOVA was the first Community programme to Croatia that provided technical assistance for the European integration process. During the whole period from 1991-2000, the EU provided EUR 367.33 million to Croatia.²⁷¹

Since 2000, in line with the Stabilisation and Association Process, consolidated assistance to Croatia under **CARDS** has increasingly focused on institution and administrative capacity building, and legislative alignment with the *acquis communautaire*. Croatia used the CARDS National Programmes until becoming a candidate (in the period of 2000-04), and it remained eligible for the CARDS Regional Programme in 2005-2006. Since becoming a candidate country in 2004, Croatia has benefited from all three pre-accession financial instruments: PHARE for institution-building and economic and social cohesion, ISPA (in the period 2005-06) for environment and transport infrastructures, and SAPARD (2006) for agricultural and rural development.

Since 1 January 2007, Croatia has been eligible for the Instrument for Pre-Accession Assistance (IPA), whose main objective is to help the beneficiary country to implement the reforms needed to meet the EU requirements and to progress in the Stabilisation and Association Process.²⁷² The IPA replaces previous pre-accession instruments, notably:

- PHARE, the scope of which is support for the implementation of the *acquis communautaire* in the form of institution building and related investments, investments in economic and social cohesion and cross-border cooperation;
- ISPA, which is the precursor of the Cohesion Fund and deals with the environment and the transport infrastructure;
- SAPARD, the precursor of the Rural Development plans, dealing with the Common Agricultural Policy *acquis* and rural development;
- CARDS, which covers the Western Balkans.

²⁷¹“Croatia the European contribution,“ European Union assistance, (2000), http://www.southeasteurope.org/documents/assist_croatia.pdf

²⁷² Dalić et al., *Glossary of the European Union Funds*, Zagreb: Central Office for Development strategy and Coordination of EU funds.

For Croatia, as a candidate country, five components apply: (i) Transition Assistance and Institution Building, (ii) Regional and Cross-Border Cooperation, (iii) Regional Development, (iv) Human Resources Development, and (v) Rural Development.

Croatia has also benefited from participation in the Community programmes. Participation in the EU programmes was reinforced in 2004, when a Protocol to the SAA was signed on the general principles for Croatia's participation in the Community Programmes. Based on the signed Memoranda of Understandings, Croatia has been participating in the following programmes:

- The 6th Framework Programme for RTD (2002-06);
- Community Employment Incentive Measures (2001-06);
- Intelligent Energy Europe (2003-06);
- Gender Equality (2001-06);
- Marco Polo (2003-06);
- Fiscalis 2007 (2003-07);
- Customs 2007 (2003-07);
- IDABC (2005-09).

Croatia also participates in the LIFE and Youth programmes as a third country²⁷³, benefits from twinning programmes, and since the beginning of 2004, the TAIEX assistance instrument is also available.

3.3.6.2 The volume of the EU Assistance

In the framework of the CARDS National Programmes, the total financial allocation for the period 2001 to 2004 reached EUR 260 million for the following four main priorities: democratic stabilisation, economic and social development, justice and home affairs, and administrative capacity.

The overall amount of EUR 260 million was committed to Croatia in the CARDS programme between 2001 and 2004. The main priorities of the CARDS assistance to Croatia in the period between 2001 and 2004 were:

- The return of refugees, sustainable development in the return areas, reconstruction and civil society development (EUR 74.70 million/28.5% of the total);

²⁷³ Central Office for Development Strategy and Coordination of EU Funds web page, <http://www.strategija.hr/Default.aspx?sec=116>

- Trade, investment climate, social cohesion, including TEMPUS (EUR 68.85 million/26.3% of the total);
- The reform of the judiciary and the police, migration and asylum, integrated border management, the fight against organised crime (EUR 62.95 million/24% of the total);
- Public administration reform, regional and local development, public finance (EUR 41 million/15.6% of the total);
- Environmental approximation, institution strengthening, monitoring and planning, investment preparation (EUR 12.50 million/4.8% of the total).

Table 3.9 EC assistance to Croatia in 1991-2000, allocations in millions of EUR

	1993	1994	1995	1996	1997	1998	1999	2000	total
Reconstruction & Technical Assistance				7.02	8.59	15.00	15.00	16.84	62.45
ECHO Humanitarian Aid	204.77		38.43	21.15	14.50	6.95	6.50	n.a	292.3
Media		0.09	0.31	0.72	1.67	0.59		0.20	3.58
Democracy & Human Rights				0.72	2.2	0.6	n.a	0.90	4.42
Demining						1.00	0.50	0.308	1.808
Customs (DG XXI)							1.00		1.00
TEMPUS								1.5	1.50
Total	204.77	0.09	38.74	29.61	26.96	24.14	23.00	19.748	367.058

Source: European Union assistance, 2nd edition, November 2000

Table 3.10 CARDS allocations between 2001–04 in the Republic of Croatia, EUR million

Sector	2001	2002	2003	2004	Total
Democratic Stabilisation	24.2	16	16	17.5	73.7
Economic & Social Development	15.6	18	16.9	17.75	68.25
Justice and Home Affairs	14.1	10	10.9	26.85	61.85
Administrative Capacity Building	2.1	12	11.65	15.1	40.85
Environment and Natural Resources	2	3	6.55	3.8	15.35
Total allocation	58	59	62	81	260

The pre-accession financial instruments PHARE, PHARE CBC, ISPA and SAPARD replaced the CARDS instrument for the period 2005-06. Pre-accession financing reached EUR 112 million in 2005 (PHARE: EUR 87 million, ISPA: EUR 25 million) and EUR 140

million in 2006 (PHARE: EUR 80 million, ISPA: EUR 35 million, SAPARD: EUR 25 million). This represented a substantial increase in the overall EC assistance compared to the amounts foreseen under CARDS for 2005 (EUR 60 million) and 2006 (EUR 62 million).

PHARE essentially continued the institution building efforts begun under CARDS with the additional element of the PHARE Economic and Social Cohesion allowing for limited investments. Cross-border cooperation had previously been financed under the regional CARDS budget, with PHARE CBC taking over and continuing to finance the Croatian participation in the neighbourhood programmes. Both ISPA, with its focus on transport and environmental infrastructure, and SAPARD, for rural development, introduced new elements of pre-accession assistance to Croatia by financing actions and investments that could previously not be addressed under CARDS.

Table 3.11 PHARE, ISPA and SAPARD allocations 2005-06 in the Republic of Croatia in EUR million

Programme	2005	2006	Total
PHARE	71.5	61.1	132.6
PHARE CBC	6	6	12
ISPA	25	35	60
SAPARD	~	25	25
Total allocation	102.5	127.1	229.6

Table 3.12 IPA Programme components for Croatia, 2007-10, EUR million

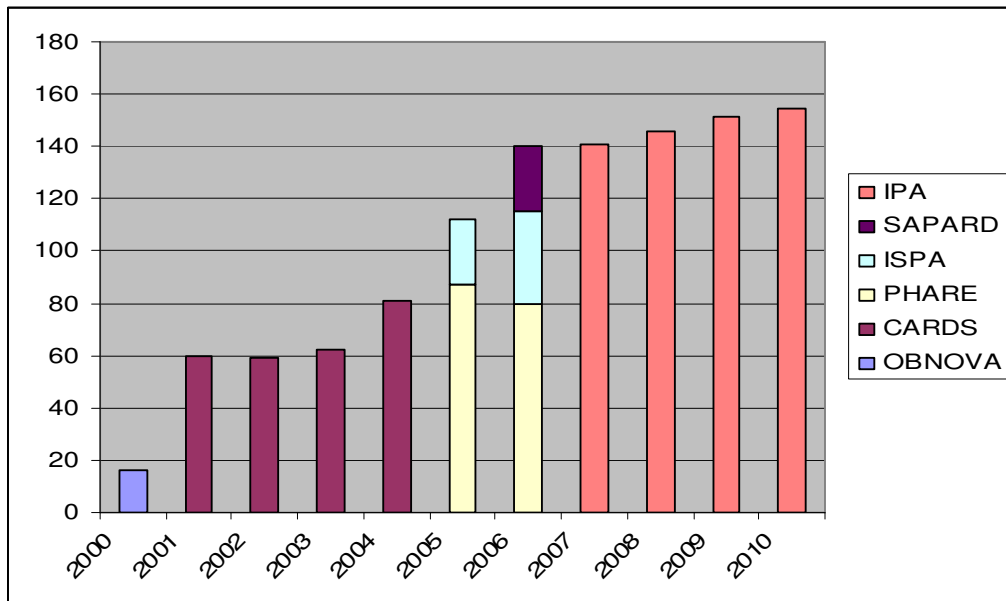
IPA programme components	2007	2008	2009	2010
Assistance in transition and institution building	47.6	45.4	45.6	39.5
Cross-border cooperation	9.7	14.7	15.9	16.2
Regional development	44.6	47.6	49.7	56.8
Human resource development	11.1	12.7	14.2	15.7
Rural development	25.5	25.6	25.8	26.0
Total	138.5	146.0	151.2	154.2

Source: Central Office for Development Strategy and Coordination of EU Funds, web, <http://www.strategija.hr/Default.aspx?sec=108>, accessed 9 December 2007

The financial value of the IPA programme in the period of six years, from 2007 to 2013, amounts to EUR 11.468 billion, as it was established by Council Regulation No. 1085/2006. The European Commission adopted the allocation of funds for a period of three years,

between 2008–2010 (including 2007). For Croatia in the above-mentioned period these funds amount to EUR 589.9 million, starting with EUR 138.5 million in 2007, with a planned constant increase in the annual amount, which in 2010 would amount to EUR 154.2 million.²⁷⁴

Figure 3.9 EU assistance allocated to Croatia in the period 2000-10



Source: Central Office for Development Strategy and Coordination of EU Funds, *Glossary of the European Union Funds*, p. 10

3.3.6.3 The Main Fields of EU Contribution

The main objective of the EU pre-accession programmes is to provide technical and financial assistance, first, for participation in the Stabilisation and Association Process (SAP) and the implementation of the obligations assumed under the Stabilisation and Association Agreement (CARDS). At a later stage (following Croatia’s candidate status and the adoption of the IPA), the pre-accession assistance is focused on implementing the reforms needed to meet the EU membership criteria.

Both the SAP and the EU membership criteria can be divided into three broad categories: political criteria, economic criteria and legal criteria (i.e. alignment with the

²⁷⁴ Central Office for Development Strategy and Coordination of EU Funds, *Instrument for pre-accession assistance – IPA*, <http://www.strategija.hr/Default.aspx?sec=108>

acquis). The EU assistance towards Croatia was first focused on the **political criteria** (including respect for human rights, refugee return, etc.). Under the political criteria, the CARDS assistance was focused on strengthening the judiciary capacities and structures through projects focusing on training systems development, court system operations and functioning. The public administration and the civil service reform have been also addressed. Concerning human rights, the protection of the minorities and civil society dialogue, the CARDS assistance facilitated the return of refugees and displaced persons with particular emphasis on sustainable regional development in the return areas, the reconstruction of the houses, public and social infrastructure, demining²⁷⁵, as well as civil society development. The PHARE projects have provided assistance for the modernisation of the justice system, the public administration reform, the protection of the minorities, in particular, that of the Roma, and civil society development.

In the **economic criteria** sector, the CARDS assistance supported capacity building related to the cadastre and property registration reform, the reform of the regulatory framework for business investments, competition policy, public procurement and intellectual property rights. The assistance also supported the reform of the public finance system, focusing on internal audit and financial control, external budget oversight, public debt management capacity, customs systems and procedures, and public finance statistics. PHARE provides further assistance to the improvement of the investment climate with a project for the modernisation of the land administration and the reform of public finances by improving the budget process for effective financial management.

Assistance under the sector **ability to assume the obligation of membership** has absorbed the largest part of the available budget allocation for Croatia since 2004, reflecting the candidate status. In that period, the CARDS assistance contributed to the improvement of trade, with actions supporting the introduction of the EU industrial standards, the development of accreditation systems, food safety, veterinary and phyto-sanitary standards, consumer protection and statistics. Social cohesion was supported through assistance to vocational training, the labour market and higher education reform efforts. Assistance to cooperation in justice and home affairs supported the improvements of integrated border management, focusing on customs and border policing, inter-agency cooperation and asylum policy and migration, as well as policing and the fight against organised crime, including trafficking in firearms, ammunitions and explosives. The CARDS assistance in the field of

²⁷⁵ Besides the CARDS assistance, support in the field of demining has been provided also through the horizontal budget line 'Action against Anti-Personnel Landmines'.

environment has resulted in further legislative alignment in the waste and water management area, environmental impact assessment and monitoring, advocacy, awareness raising and the promotion of renewable energy sources, as well as investment preparations.

The Projects under PHARE continue to address the areas of trade, customs and taxation, agriculture and fisheries, transport, social cohesion, statistics, environment and natural resources, policing and the fight against corruption and organised crime, as well as border management. The ISPA programme contributed to environmental and transport related infrastructure investments.

The SAPARD programme started in 2006. The programme, as well as the SAPARD agency, constitute the basis for the development of the IPARD programme and agency. Under the sector supporting programmes, PHARE has provided assistance to national, regional and local development capacity building, the participation of Croatia in community programmes including TEMPUS, and it also includes a project preparation and institution building reserve, a continuation of the administrative capacity building facilities introduced under CARDS.

3.3.6.4 Impact on economic development

The screening process has also raised the awareness of the importance of the EU assistance projects at the political level. Many reforms that have already been undertaken to comply with the EU *acquis* are a direct result of the CARDS assistance.²⁷⁶

The implementation of CARDS and the pre-accession instruments assistance projects in Croatia has shown that (i) the weak administrative absorption capacity in Croatia's public administration bodies is reducing the effectiveness of the EC assistance and (ii) that greater political support is needed, as the public administration has to meet project conditionalities, such as policy decisions, the establishment and strengthening of institutions, and the allocation of resources. The proper staffing of the units charged with implementing projects, and support from the top management and political level in ministries is necessary for successful project results.²⁷⁷ This might have an impact on strengthening expert positions in the public administration (as opposed to political appointments) and the implementation of reforms that without the EU conditionality would not be priorities. Such reforms might create

²⁷⁶ European Commission, Commission decision C (2007)2566 of 20/06/2007 on a Multi-annual Indicative Planning Document 2007 - 2009 for Croatia, (Brussels, 2007).
http://ec.europa.eu/enlargement/pdf/mipd_croatia_2007_2009_en.pdf

²⁷⁷ http://ec.europa.eu/enlargement/pdf/mipd_croatia_2007_2009_en.pdf

conditions for economic development through institution building (e.g. help fighting high-level corruption or increasing the efficiency of the public administration), and the development of the infrastructure.

In June 2005, the National ISPA Coordinator submitted applications for EC assistance under the ISPA instrument, together with final drafts of the National ISPA Strategies for environment and transport. The overall cost of the proposed investment amounts to approximately EUR 125 million, of which approximately EUR 63 million is proposed for ISPA financing. The remaining EUR 62 million is to be financed from national resources (including in part loans from international financial institutions). In addition, the EU assistance might be regarded as a catalyst in defining priorities and identifying the measures necessary for achieving the reform goals. In July 2004, the Croatian government adopted a paper called “Pre-Accession Assistance Needs (PAAN)”. This might be regarded as an improvement in managing reforms, in terms of defining priorities and their sequencing, which were identified as a significant impediment for successful reform implementation.²⁷⁸

3.4 Legal adaptation

3.4.1 The evaluation of the national legal system

3.4.1.1 Transformation since 1990

There has been intensive legislative activity in Croatia since its independence, while the efforts to align the Croatian legal system with the EU one started in 1999. The intention of the Croatian government to participate in the integration process, specifically through legal harmonisation, was confirmed by the Conclusion of the Government of the Republic of Croatia of 28 January 1999 on the obligation of the ministries and state executive organisations to respect the laws of the EU when drafting bills and other regulations. Thus, a basis was created for all new Croatian laws to be adjusted with the law of the EU. At the time, contractual relations between Croatia and the EU were not established, and Croatia had no legal obligation to harmonise with the EU legal system. This provided an opportunity to select only priority areas for approximation, while the necessity to ensure full compliance with the single market regulations was recognised.

²⁷⁸ For the summaries of this topic, see, for instance, Katarina Ott, “Croatian accession to the European Union: the challenges of participation,” in *Croatian Accession to the European Union: The Challenges of Participation*, ed. Katarina Ott (Zagreb: Institute of Public Finance: Friedrich Ebert Stiftung, 2006), 1-27.
<http://www.ijf.hr/eng/EU4/ott.pdf>

The first evaluation of the compatibility of the Croatian law with the law of the EU was presented in the Action Plan for European Integration in 1999²⁷⁹. The preliminary evaluation of the compatibility of the Croatian law with the law of the EU differentiated several levels of compatibility: (i) completely or partly compatible, (ii) totally incompatible or (iii) that the regulation of the particular legal area does not exist. If the evaluation showed partial compatibility, comments indicated which parts of the Croatian legal instrument were adjusted and which ones were not. Some explanations of the reasons why certain areas have or have not been adjusted (especially whether it was consciously decided to postpone the approximation, taking into consideration the conditions and requirements of the Croatian economy) were also given, as well as information whether there was a draft of the new Croatian legislation, what phase it was in, and to what extent the proposal had been adjusted to the EU legislation. A note on implementation was also provided.

The evaluation of the compatibility of the Croatian law with the EU in 1999 showed that the approximation process in Croatia had already begun in some areas, where the appropriate market legislation (such as company law, competition, accounting, auditing, VAT, banking, telecommunications and customs law) was adopted, and appropriate institutions were established and operational (e.g. the Agency for the Protection of Market Competition, the Securities Commission, the State Agency for Standardisation, the Intellectual Property Agency, and independent auditing agencies). On the other hand, a number of areas were recognised in which there was no appropriate legislative framework or/and the necessary institutions (such as consumer protection and advertising, data protection, or state aids).

The voluntary alignment continued until 2002, when the Interim Agreement entered into force and created the obligation for legal alignment in the priority areas related to the internal market. In 2001, when the Stabilisation and Association Agreement was signed, the domestic harmonisation procedures were amended in order to speed up the process.

Since December 2001, the state administrative bodies have to submit a statement of compatibility and an accompanying table of the concordance of the legislative provisions of the Republic of Croatia with the relevant EU provisions together with the draft texts of the new Croatian laws.²⁸⁰ A European Integrations Committee tasked to follow up the

²⁷⁹ Government of Republic of Croatia, *Action Plan for European Integration* (Zagreb: Office for European Integration, 1999), 63.

²⁸⁰ This obligation was initially introduced by a government's decree and reinforced in 2002, when the parliament adopted a conclusion requiring the government of Croatia to ensure that only draft acts accompanied by a statement of compatibility and a table of concordance are forwarded to the parliament.

harmonisation process was also established in the parliament in 2001, and the parliament's Standing Orders were amended to enable a summary procedure for draft legislation to be harmonised with the EU *acquis*.²⁸¹ A distinction was made between draft legislation that should be harmonised with the *acquis* and other "ordinary" draft legislation. Unlike in the case of other draft legislation, voting on enabling the use of the summary procedure for legislative proposals to be harmonised with the EU is not required. The summary procedure means that the first and second readings are combined: in the same reading, amendments have to be both discussed and decided on. Proposals can be enacted under the summary procedure if so sought by the sponsor, unless the competent working body (which is either the Committee on the Constitution, Standing Orders and Political System or the Legislation Committee) proposes discussion and debate in the first reading due to its failure to comply with the Constitution or the legal system.

According to the government's Standing Orders²⁸², all laws that the government proposes have to be adjusted with the EU *acquis*. Hence, the government can seek the urgent procedure for every single law that it proposes. Since in this procedure the ability to analyse the proposed amendments and/or their adjustment with EU regulations is limited, these provisions enable, in practice, the very reverse of what is desired to be achieved. At the same time, limiting the debate makes the understanding of the integration process and the demands that it makes more difficult at all levels – from the decision makers to the general public that follows their work. The summary procedure, in addition, enables a perception that in the framework of the "European laws" some laws are passed that are not necessary for the integration process but for the attainment of "ordinary" political objectives.²⁸³ This leads to the marginalisation of the parliament's role and the need for speed clashes with the goal of fostering democracy.²⁸⁴

²⁸¹ Croatian Parliament, "Standing Orders," *Official Gazette* no. 117 (2001). English version available at: Croatian Parliament Important Legislation. "Standing orders of the Croatian Parliament." Croatian Parliament. <http://www.sabor.hr/Default.aspx?art=2434>

²⁸² Government Standing Orders, *Official Gazette* 07 /2000

²⁸³ Ana-Maria Boromisa, "The readiness of the public administration for European Union accession," in *Croatian accession to the European Union, institutional challenges*, ed. Katarina Ott (Zagreb: Institute for Public Finances : Friedrich Ebert Stiftung, 2004), 180.

<http://www.ijf.hr/eng/EU2/Boromisa.pdf>

²⁸⁴ C.f. Tomislav Maršić, "Assessing the negotiation experience: quick accession or good representation?," in *Croatian Accession to the European Union: the Challenges of Participation*, ed. by Katarina Ott (Zagreb: Institute of Public Finance: Friedrich Ebert Stiftung, 2006), 29-56, <http://www.ijf.hr/eng/EU4/marsic.pdf>

The Interim Agreement that entered into force in 2002 and created the formal obligation for legal alignment in the priority areas related to the internal market. However, the harmonisation process implemented through co-operation between state administrative bodies in the phase of the preparation of the legislative proposals, and the Croatian parliament in the phase of the adoption of the laws, does not differentiate between the priority and other areas of the *acquis*. This approach was explained by the need for preparations for membership, which is not limited by the implementation of the Stabilisation and Association Agreement.

3.4.1.2 Pre-accession help and actions

As mentioned before the EC assistance has been oriented towards alignment with the membership criteria since 2000. The total allocations for the development of the ability to assume the obligations of the membership in the period 2001-06 was EUR 184.47 million (EUR 107 million under CARDS and EUR 77.47 million under the PHARE programme).²⁸⁵ The objective of the pre-accession assistance provided to Croatia under the IPA since 2007 is to assist in meeting the accession criteria, i.e. the political and economic criteria, as well as the adoption, implementation and enforcement of the *acquis communautaire*. The screening process has identified the remaining legal gaps and the final stage of the alignment process should focus on these issues. The plans for the period 2007-09 are based on an indicative financial envelope of EUR 438.4 million.²⁸⁶

In January 2008, the endorsement of the contracts under the PHARE 2006 programme has been suspended. The measure is expected to be temporary (for three months), until the benchmarks imposed by the EU are not met. Improvements are expected in the management and the quality of the project tender dossiers resulting from insufficient administration capacities at the Ministry of Finance.²⁸⁷ As the main challenges for the period 2007-09 identified by the Commission include the public administration reform, it is somewhat odd that the assistance has been suspended because of the weakness of the administrative capacities of the Ministry of Finance.

²⁸⁵ European Commission, Commission decision C (2007)2566 of 20/06/2007 on a Multi-annual Indicative Planning Document 2007 - 2009 for Croatia (Brussels, 2007). http://ec.europa.eu/enlargement/pdf/mipd_croatia_2007_2009_en.pdf

²⁸⁶ Multi-annual indicative planning document for Croatia, op. cit.

²⁸⁷ Delegation of the European Commission to the Republic of Croatia. "Media Briefing on the Suspension of Endorsement of the PHARE 2006 project contracts by the European Commission: Statement of Mr Oskar Benedikt, Counsellor at the EC delegation." News, <http://www.delhrv.cec.eu.int/en/content/news/id/996>

3.4.2 Comparative analysis according to the EU negotiation chapters

The gaps between the Croatian legislation and the *acquis communautaire* presented in this chapter are identified on the basis of the screening reports, the progress report from November 2007, and the progress of the negotiations.

3.4.2.1 Single Market

The *acquis* related to the single market signifies policies and measures relating to the free movement of goods, services, workers and capital. As opposed to the fifth enlargement, when 4 (of the 31) negotiation chapters dealt with the single market²⁸⁸ before opening negotiations with Croatia, the *acquis* was divided into 35 chapters. The free movement of goods is dealt with in two negotiations chapters, Chapter 1: Free movement of goods and Chapter 7: Intellectual property law. The free movement of persons is also dealt with in two chapters: Chapter 2: Freedom of movement for workers and Chapter 3: Right of establishment and freedom to provide services. These chapters, together with Chapter 9, relate to freedom to provide services, while Chapter 4 deals with the free movement of capital.

Table 3.13 Negotiation chapters dealing with the single market

1. Free movement of goods	1. Free movement of goods
	7. Intellectual property law
2. Free movement of persons	2. Freedom of movement for workers
	3. Right of establishment and freedom to provide services
3. Freedom to provide services	3. Right of establishment and freedom to provide services
	9. Financial services
4. Free movement of capital	4. Free movement of capital

Chapter 1 - **Free movement of goods** is regarded as one of the hardest negotiation chapters. It is regulated with a regiment of technical standards, rules, directives and regulations. The screening report indicates that the Croatian legislation is partially in line with the *acquis* in Chapter 1, but implementing the structures needs to be completed and further upgraded, especially as regards the horizontal measures.

Croatia has produced plans for alignment in many areas. However, these plans do not cover the general principles deriving from Articles 28-30 of the EC Treaty and the related

²⁸⁸ I.e. Chapter 1 – free movement of goods, Chapter 2- Free movement of persons, Chapter 3 Freedom to provide services and Chapter 4 –Free movement of capital.

case law. Several sectors are not adequately covered by the alignment plans, and the target dates for the legislation are not coordinated with the steps necessary to build the necessary implementing structures. Sector legislation is developed without the prior completion of the basic framework which is needed in particular for the proper operation of the conformity assessment procedures and in order to complete the segregation of tasks between the regulatory, standardisation, accreditation, metrology, conformity assessment and market surveillance functions.²⁸⁹

Before opening negotiations on this chapter, Croatia has to meet three benchmarks. The first one is to restrict all infrastructure procedures (accreditation, standardisation, conformity assessment procedure, legal metrology, market surveillance). The second benchmark determines establishing a universal strategy for the implementation of the EU *acquis communautaire* in this chapter (including deadlines of implementations, legislative measures, and improving administrative competence for all sectors). The third benchmark requires an Action Plan for eliminating measures having equivalent effects.

The *acquis* on **intellectual property law** specifies harmonised rules for the protection of copyright and neighbouring rights, for industrial rights, and it contains provisions on enforcement. Croatia believes that it can accept the *acquis* regarding intellectual property rights and that it will have no difficulties in implementing the *acquis* by the accession. The EU shares this view: it believes that Croatia has a high level of legislative alignment with the community *acquis* in the area of intellectual property rights, and while it possesses a certain enforcement capacity, this needs further improvement.²⁹⁰ Negotiations on this chapter are under way, and two closing benchmarks are identified.

The *acquis* under the chapter **free movement for workers** provides the right to EU citizens to move freely, to stay and to work, with some exceptions in the public sector, in another Member State without being discriminated against on grounds of nationality. Croatia has reached a satisfactory level of alignment in the field of the freedom of movement for workers. However, there is a need for adjustment with the EU rules on the access to the labour market, mainly as regards non-discrimination against EU migrant workers. Considerable and sustained efforts are required also in particular in terms of developing the administrative capacity for the co-ordination of the social security systems. The efforts need

²⁸⁹ European Commission, *Screening report Croatia: Chapter 1 – Free movement of goods* (Brussels, 2007), http://ec.europa.eu/enlargement/pdf/croatia/screening_report_01_hr_internet_en.pdf

²⁹⁰ European Commission. *Screening report Croatia: Chapter 7 – Intellectual property law* (Brussels, 2007), http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_07_hr_internet_en.pdf

to continue in view of the future participation in the EURES network, as well as in view of the introduction of the European Health Insurance Card after the accession.

The right of establishment and freedom to provide services provides economic subjects free supply of services throughout the EU, regardless in which Member State the headquarter is located . On the other hand, Member States must ensure that the right of the establishment of the EU national and legal persons and the freedom to provide services is not blocked by the national legislation. Croatia has identified itself most of the problematic issues. In the area of the mutual recognition of professional qualifications (especially minimum training requirements), Croatia is very close to meeting the requirements of the *acquis*. However, the Croatian legislation diverges from the *acquis* on two essential points. The Act on the recognition of foreign educational qualifications does not distinguish between the recognition of academic and professional qualifications. The second difference is in the nationality requirements, which restrict access to certain professions to Croatian citizens. Also, there is a need to change the Croatian legislation, which requires a proof of work experience before granting a licence to a foreigner for exercising a profession.

According to the screening report, Croatia²⁹¹ is well aware of most of the incompatibilities with the *acquis* in the area of the right of establishment. It has presented a precise timetable for alignment. As regards postal services, the *acquis* also aims to open the sector of postal services to competition in a gradual and controlled way. Croatia has achieved a good level of alignment, but it needs to strengthen the position of the Council for Postal Services as the National Regulatory Authority. Certain provisions linked to the quality of service should be amended. A problematic issue in this area of postal services is supervision structure. The negotiations on this chapter are open, and six closing benchmarks have been set.

Chapter 9 – **Financial services** also regulates freedom to provide services. This chapter includes rules for the authorisation, operation and supervision of financial institutions and regulated markets. Financial institutions covered by the *acquis* can operate across the EU in accordance with the ‘European passport’ and the ‘home country control’ principle either by establishing branches or by providing services on a cross-border basis. Overall, Croatia’s legislation is satisfactorily aligned to the financial services *acquis*. Alignment has progressed further in the areas of banking and financial conglomerates, and of insurance and occupational pensions. The necessary supervisory authorities are established. However, their

²⁹¹ European Commission, *Screening report Croatia: Chapter 3 – Freedom to provide services* (Brussels, 2007), http://ec.europa.eu/enlargement/pdf/croatia/screening_report_03_hr_internet_en.pdf

competences need to be further strengthened. Croatia believes that it can accept the *acquis* regarding financial services, and that it does not expect any difficulties in implementing the *acquis* by the accession.²⁹² The negotiations on this chapter are open, and 5 closing benchmarks have been defined.

Chapter 4 – **The free movement of capital** requires the abolishment of the restrictions for the movement of capital both within the EU and between Member States and third countries. The *acquis* also includes rules concerning cross-border payments and the execution of transfer orders concerning securities.

Croatia has reached a reasonable level of alignment with the *acquis*, but it needs to make further progress in the area of the acquisition of real estate by foreigners, outward portfolio investment by residents, short-term credit and cash transactions, and restrictions on institutional investors.²⁹³ On the one hand, Croatia complies with its obligations under the Stabilisation and Association Agreement (SAA), but on the other, there is the exception of the acquisition of real estate by EU citizens. Croatia has achieved a good level of alignment with the *acquis* in the area of payment systems, but full alignment has yet not been achieved in the area of money laundering. For the opening of this chapter, two benchmarks should be met. The first benchmark relates to the adoption of an Action Plan for fight against money laundering and the second to the implementation of the existing procedures in the area of the acquisition of real estates by EU citizens.

It can be concluded that Croatia has made progress in the alignment with the single market. Still, many elements of the *acquis* are not yet in place. Croatia's estimate of its implementing capacity is more optimistic than the estimate of the European Commission. However, even Croatia considers that difficulties might represent

- complying, upon accession, with the data exclusivity provisions requiring a period of ten years (currently in Croatia 6 years is required)

- upgrading in time for the accession the marketing authorisations of the existing products not authorised on the basis of the requirements foreseen by the Community *acquis*.²⁹⁴

²⁹² European Commission, Screening Report Croatia : Chapter 9 – Financial services (Brussels, 2006).

http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_09_hr_internet_en.pdf

²⁹³ European Commission, Screening report Croatia: Chapter 4 – Free movement of capital (Brussels, 2007).

http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_04_hr_internet_en.pdf

²⁹⁴ European Commission, Screening report Croatia: Chapter 1 – Free movement of goods (Brussels, 2007).

http://ec.europa.eu/enlargement/pdf/croatia/screening_report_01_hr_internet_en.pdf

3.4.2.2 Investments

The implementation of the Stabilisation and Association Agreement (SAA) should create a new investment climate, which is considered to be crucial to economic restructuring and modernisation.²⁹⁵

In addition to the general goals of the SAA, defined by Preamble, several provisions of the SAA regulate investment-related issues.²⁹⁶ These provisions relate to:

- The acquisition of real estate in Croatia by the nationals of the EU Member States,
- Investment promotion and protection
- Investment in the tourism sector
- Attracting investments and fostering the interoperability of networks and services necessary for an information society
- The implementation of infrastructure projects of common interest.

According to the SAA, Croatia has to authorise, by making full and expedient use of its existing procedures, the acquisition of real estate in Croatia by the nationals of the Member States of the European Union. The exceptions are agricultural land as defined by the Agricultural Land Act (Official Gazette no.54/94, consolidated text, 48/95, 19/98 and 105/99) and the areas protected under the Environmental Protection Act (Official Gazette no. 30/94). Within four years from the entry into force of the SAA, Croatia shall progressively adjust its legislation concerning the acquisition of real estate in Croatia by the nationals of the Member States of the European Union to ensure the same treatment as compared to Croatian nationals. At the end of the fourth year, after the entering into force of the SAA, the Stabilisation and Association Council shall examine the modalities for extending these rights to agricultural land and the areas protected under the Environmental Protection Act.

A four-year transition period is foreseen for the liberalisation of capital movements relating to portfolio investment and financial loans and credits with a maturity shorter than a year. Any restrictive measures shall not apply to transfers related to investment and in particular to the repatriation of amounts invested or reinvested in any kind of revenues stemming therefrom.

²⁹⁵ “Zakon o potvrđivanju Sporazuma o stabilizaciji i pridruživanju između Republike Hrvatske i Europskih zajednica i njihovih država članica,” *Official Gazette*, no. 14 (December 27, 2001)

²⁹⁶ E.g. Article 50, Article 60, Article 85, Article 88, Article 99, Article 107.

Article 85 of the SAA regulates investment promotion and protection. It provides for the improvement of the legal framework in Croatia aimed at fostering investments and their protection and promotes the conclusion of bilateral agreements for the promotion and protection of investment.

On sector-specific issues, the SAA regulates investment in tourism and the information society. It explicitly states that cooperation in tourism includes in particular encouraging the development of an infrastructure conducive to investment in the tourism sector. The strengthening of cooperation with the objective of further developing the information society in Croatia has as the goal of attracting investments. Furthermore, EU assistance is defined as having two basic forms: institution-building and investment. The assistance shall contribute to the democratic, economic and institutional reforms of Croatia, while considering the full implementation of the infrastructure projects of common interest identified in Protocol 6. These are Pan-European Corridors V, VII, X and the Adriatic/Ionian Pan-European Transport Area connecting to Corridor VIII. The development of a multimodal regional transport network on the Croatian territory, which serves the needs of Croatia and the South Eastern European region, covering the main road and rail routes, inland waterways, inland ports, ports, airports and other relevant modes of the network, is also identified as of particular interest to the Community and Croatia. This network shall connect to the regional, Trans- or Pan-European networks of the neighbouring countries and be interoperable with the Trans-European Transport Network of the Community. The respective projects and priorities are assessed in accordance with the methods used in the Transport Infrastructure Needs Assessment (TINA), taking into account the TINA results in the neighbouring countries.

The SAA stipulates the necessity for substantial investments in the infrastructure and also defines that transition periods would be needed in some investment-related areas. As investment issues are of importance for Croatia and the EU Member States, the implementation of some of these issues has already been discussed with the neighbouring states (e.g. Italy). The investment-related issues are of significant importance for the alignment with the EU policies, notably in the fields of energy and transport.

3.4.2.3 Environment

The aim of the EU environment policy is sustainable development and environmental protection. The *acquis communautaire* in this chapter consists of over 200 main regulations,

including horizontal legislation, quality of water and air, waste management, nature protection, industrial pollution control and risk management, forest protection, chemicals, genetically modified organisms (GMOs), and noise protection. Compliance with the *acquis communautaire* requires investments and strong and well-equipped administration at the governmental and the regional level. According to Croatia's assessment, difficulties with the implementation of some parts of the *acquis* may be expected due to the high costs of the needed investments²⁹⁷. Croatia has taken concrete steps in all fields within the chapter to prepare for the transposition of the remaining parts of the *acquis* by the end of 2008.

As regards horizontal legislation, the Commission considers that the Croatian legislation in this area is partially in line with the *acquis*, while the administrative capacity in the area of climate change and horizontal legislation is limited. In the areas of air quality, waste management, industrial pollution and risk management, progress in the transposition of the *acquis* has been achieved, but it is expected that the implementation will require large-scale investments. The further strengthening of the administrative capacity will be also necessary²⁹⁸. Next, Croatia will have to make significant efforts to align its legislation with the *acquis* in the area of water quality, and it should accelerate completing the alignment with the noise-related *acquis*. Croatia is well advanced in the area of nature protection and chemicals, while positive steps have been made in terms of alignment with the *acquis* on GMO²⁹⁹.

In general, the institutions responsible for implementation and enforcement are in place at the national, county and local level, though they need to be strengthened. To that end, Croatia should ensure an adequate number of staff, the provision of training and the purchase of equipment, and that the timetable for the reinforcement of the administrative capacity is coherent with the plan for legislative alignment. As the costs of the adjustment of the existing installations to the requirements of the *acquis* will be high, Croatia should ensure that adequate financial resources will be at its disposal and that there is coherence between the financial resources made available and the timetable for the legislative alignment³⁰⁰.

²⁹⁷ European Commission, *Screening report Croatia: Chapter 27 – Environment* (Brussels, 2007), 2. http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_27_hr_internet_en.pdf

²⁹⁸ European Commission, *Croatia 2007 Progress Report SEC (2007) 1431* (Brussels, 2007). http://ec.europa.eu/enlargement/pdf/key_documents/2007/nov/croatia_progress_reports_en.pdf

²⁹⁹ *Id.* at 24.

³⁰⁰ *Id.* at 20.

Despite significant progress on the environmental chapter, Croatia has not opened negotiations. An opening benchmark has been defined, requiring the development of a comprehensive plan for putting in place the necessary administrative capacity at national, regional and local levels, as well as financial resources to implement and enforce the *acquis*. It is expected that the necessary reforms will be financed from the state budget, but also from the private sector and from the local level. The coordination of the different bodies responsible for environment-related issues has deficiencies and it requires improvement. Croatia needs to take steps to integrate the environmental protection requirements into the definition and implementation of all other policies and to promote sustainable development. Given the scope and nature of the *acquis* in this chapter, considerable efforts are needed to fully meet the EU requirements.³⁰¹

3.4.2.4 Consumer protection

Consumer protection is part of the *acquis* under the chapter Consumer and Health Protection. This chapter consists of horizontal policy instruments, including financial support, regulatory and governing measures as well as vertical policies. The implementation and enforcement of consumer protection policies require adequate administration capacities and infrastructure at the national, regional and local levels. It is also necessary to raise public awareness, consult with the public and involve consumers actively in effective policy implementation, thus informing and educating the consumer and ensuring a role for consumer associations³⁰².

Overall, Croatia has already reached a good level of alignment with the *acquis*. However, it needs to finalise its transposition process on quite a number of EU measures in both parts of the chapter. It also needs to strengthen its administrative capacity for *acquis* enforcement. The 2007 Progress Report recognised that Croatia is undertaking efforts to develop a consumer protection system in line with the EU Consumer Protection strategies and values. Further alignment needs are identified by the analysis made in 2006, mostly as horizontal aspects. In addition, Croatia needs to continue to prepare for the participation in the RAPEX system. Consumer movements are not sufficiently supported and alternative channels for settling consumer disputes are not sufficiently developed.

³⁰¹ Id. at. 60

³⁰² European Commission, *Screening report Croatia: Chapter 28 – Consumer and health protection* (Brussels, 2007), http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_28_hr_internet_en.pdf

Negotiations in this chapter are open, and four benchmarks for closing the negotiations are set. Two of them relate to legal adjustment, and two to implementation capacity. The necessary legal adjustment has been already made and recognised by the 2007 Progress report. Amendments to the General Product Safety Act were adopted by the parliament in October 2007 (i.e. one benchmark has been met). Good progress has also been made in the area of non-safety related issues by the adoption of a new Consumer Protection Act in July 2007. The new law aims at ensuring further alignment in many areas of the *acquis*, such as unfair terms in consumer contracts, price indication, doorstep credits, distance sales, distance marketing of financial services, consumer credits, misleading/comparative advertising, unfair commercial practices, timeshare and package travel, which relate to the second benchmark.³⁰³

Support for meeting the remaining benchmarks relate to the strengthening of the administrative capacity, for implementation in this area is provided under the CARDS 2004 programme “Further Capacity Building in the Area of Consumer Protection“. The implementation of the EUR 1.1 million project started in July 2007, and it should be finalised in 24 months, contributing to an improved level of consumer protection in Croatia.³⁰⁴

3.4.2.5 Labour legislation

Labour legislation is an important part of the *acquis* relating to the single market (i.e. the free movement of persons) and is also dealt with in a special chapter, that of social policy and employment. The *acquis* in this chapter includes minimum standards in areas such as labour law, gender equality in labour market and social security, as well as health and safety at work. Specific binding rules have also been developed with respect to non-discrimination on grounds of racial or ethnic origin, religion or belief, disability, age, or sexual orientation. Croatia believes that it can accept the *acquis* regarding social policy and employment and does not expect any difficulties in implementing the *acquis* by accession³⁰⁵.

³⁰³ European Commission, *Croatia 2007 Progress Report SEC (2007) 1431* (Brussels, 2007), 60 – 61. http://ec.europa.eu/enlargement/pdf/key_documents/2007/nov/croatia_progress_reports_en.pdf

³⁰⁴ Poslovni dnevnik, “Projekt za jačanja zaštite potrošača u Hrvatskoj,“ <http://www.poslovni.hr/62624.aspx>

³⁰⁵ European Commission, *Screening report Croatia: Chapter 19: Social policy and employment* (Brussels, 2006), 2. http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_19_hr_internet_en.pdf

As regards labour law, the main EU principles are in place, but the administrative capacity of the relevant ministry (the Ministry of Economy, Labour and Entrepreneurship) needs to be substantially strengthened. The Commission estimates that good progress has been achieved in the area of the employment policy, as the government has adopted the Employment Action Plan 2005-08 and the Annual Plan for Employment Promotion for 2007, aimed at tackling problems related to the low employment rate and the relatively high unemployment rate. The plan contains measures aimed at increasing the flexibility of the labour market and adult education and training.

For opening negotiations in the social policy and employment chapter, an Action Plan has to be adopted, defining a timeframe for the adoption of the directive, as well as the human resources, institutions and funds necessary for the implementation.

3.4.2.6 State aids

The competition *acquis* deals with state aid control policies and the rules aimed at preventing governments from granting state aid which distorts competition in the internal market. Croatia started alignment with the EU *acquis* following its entry into the WTO. At the time, Croatia did not have a subsidy programme *per se*, but rather an industry rehabilitation and reorganization programme. The government assisted the areas that were heavily devastated during the war by financing the payroll of seven enterprises located there and involved in the production of steel, steel refining and textiles, at an accumulated cost of approximately USD 3.2 million by mid-1996. The Croatian Railways were also subsidized in the post-war period at the level of some USD 400 million by the end of 1996. The government also subsidized the sea transport of tourists by paying the difference between the revenues and the expenditure on popular tourist lines and connections (about USD 31 million in 1995 and USD 35 million in 1996).

In the process of accession to the WTO, Croatia was not able to provide sufficiently detailed information on its subsidization policies, in particular with regard to policy objectives, levels of subsidization, effects, and the duration of such policies.³⁰⁶ Against this background, it is not surprising that Croatia has not reached a satisfactory level of alignment with the *acquis*, nor does it have the administrative capacity to do so at this stage. Croatia needs to further align its legislation, strengthen its administrative capacity and have a more

³⁰⁶ “WTO accession document, Croatia”, <http://www.wto.org>

effective enforcement record. Special attention is needed in particular as regards state aid to steel and shipbuilding, as well as in the area of fiscal aid.

The Competition Agency supervises the state aid in Croatia and the latest improvements of the State Aid Act (in 2005) enabled the Competition Agency to issue binding decisions in the state aid sector. Despite this improvement, the current system is insufficient, particularly as regards the power of the government to overturn decisions. In the pre-accession period, Croatia needs to reduce and restructure state aid. The size of state aid in Croatia, measured by its share in the GDP, is four times larger than that in the EU. The largest portion (56% on average) of state aid in Croatia in the period 2001-04 was allocated to selected economic sectors, while sector specific aid accounted for only 25 % of the total aid in the EU-15. Transport, shipbuilding, ironworks and the rescue and restructuring of businesses account for almost 80 percent of sectoral aid.

Aid to transport can be divided in two groups: aid to railways and aid to other transport sectors. Aid to railways in the period 2001-04 accounted for 80% of the total aid to the transport sector. Therefore, Croatia has to reform its state aid by drawing a strict line between supporting the services of general interest or investment in the infrastructure (which is not considered as state aid) and transfers for covering current losses.³⁰⁷ According to the screening report, Croatia should define the scope of Services of General Economic Interest (SGEI) in its legislation.

The aid to shipbuilding in Croatia amounts to a high 20% of the total aid (compared with 2% in EU) and should go through a comprehensive reform oriented towards research and development, the innovation or the closure of shipyards, and related aid aimed at job creation, exports of development, as well as regional aid. Croatia needs to adopt a regional aid map before granting any regional aid measures, and generally downsize the rescue aid to shipbuilding. Namely, the rescue and restructuring aid in the EU should be granted on the “one time, last time” principle. This also holds for the steel sector, where the two existing companies (the Sisak Pipe Rolling Mill and the Split Iron Mill) are experiencing serious difficulties and are constantly obtaining operating aid. The aid granted should be based on individual business plans and a national restructuring programme in line with the requirements set out in the Stabilisation and Association Agreement.

The Commission has recognised some progress in the area of fiscal aid, but there is a need for further legislative alignment and the strengthening of the administrative capacity.

³⁰⁷ Kesner Šrkec and Ivana Jović, *Towards Less and Better State Aid in Croatia*, Newsletter no 29 (Zagreb: Institute of Public Finance, June 2007)

For opening negotiations on competition, four benchmarks have to be met regarding the shipbuilding industry, the steel sector, the alignment of the legislation in the area of fiscal aid (namely the Free Trade Act, the draft of which has not been aligned with the *acquis*), and for state aid in general.

3.4.2.7 Liberalisation

The term ‘liberalisation’ refers to Article 3 of the EC Treaty, which states that the activities of the Community shall include a system ensuring that competition in the internal market is not distorted. For this purpose, there is a specific surveillance system in the case of public undertakings and undertakings to which Member States grant special or exclusive rights. With respect to the liberalisation of specific sectors, reference is made to the relevant sector specific negotiating chapters.³⁰⁸

Croatia holds that the rules applied to companies performing services of general economic interest under the State Aid Act and the Act on market competition are in line with Article 86(2) of the EC Treaty. However, the EU does not share this view, and according to the screening report, the system currently in place does not fully reflect the EU rules. Croatia should define the scope of Services of General Economic Interest (SGEI) in its legislation and needs to ensure that anti-trust rules and EU state aid rules are applied in full to public undertakings and undertakings with special or exclusive rights, in accordance with Article 86 of the EC Treaty and with the definition of ‘undertaking’ in the *acquis*. Croatia also needs to ensure that the EU rules on the transparency of the financial relations between the public authorities and public undertakings apply.

As there are no national monopolies of a commercial character in Croatia, this aspect of the liberalisation is in line with the EU rules, and Croatia should keep the Commission informed of any new developments in this area.³⁰⁹

³⁰⁸ European Commission, *Screening report Croatia: Chapter 8 – Competition policy* (Brussels, 2007). http://ec.europa.eu/enlargement/pdf/croatia/screening_reports/screening_report_08_hr_internet_en.pdf

³⁰⁹ Id. at. 7-12

3.4.3 Official positions on the future of legal adaptation

Croatia considers that in most of the chapters it can accept the *acquis* before the accession. According to the official views, as presented in the screening reports³¹⁰, there are six chapters in which Croatia is likely to need transition periods:

- the free movement of goods (chapter 1),
- the free movement of capital (chapter 4),
- transport policy (chapter 14),
- energy (chapter 15),
- taxation policy (chapter 16), and
- environment (chapter 27)

Croatia indicates that it can accept the *acquis* regarding the **free movement of goods**, and it does not expect any difficulties in implementing the *acquis* by the accession, except for the following:

- complying, upon accession, with data exclusivity provisions requiring a period of ten years (currently in Croatia 6 years is required); and
- upgrading in time for the accession the marketing authorisations of the existing products not authorised on the basis of the requirements foreseen by the Community *acquis*.

Regarding the **free movement of capital**, Croatia can accept the *acquis*, but real estate acquisition is an issue of special concern. The acquisition of real estate is among the areas where Croatia would need adequate transition periods. Croatia will define its timetable for alignment with the *acquis* in its negotiating position on this chapter. Croatia has indicated that it can accept the *acquis* regarding **transport**, but that it does expect some limited difficulties in implementing the *acquis* by the accession. In **energy**, due to the considerable investments deemed necessary by Croatia for complying with the *acquis* on oil stocks, the energy performance of buildings, energy end-use efficiency and energy services, Croatia expects some difficulties in implementing the *acquis* in these areas by the date it foresees for its accession. Croatia has accepted the *acquis* regarding **taxation** and stated not to expect difficulties in implementing the *acquis* by the time of accession. However, Croatia has

³¹⁰ Screening Reports, available at http://ec.europa.eu/enlargement/croatia/screening_reports_en.htm

indicated that it would request transitional periods in certain areas. Concerning the **environment**, difficulties with the implementation of some parts of the *acquis* may be expected due to the high costs of the needed investments. Also, the administrative structures in charge of the implementation and enforcement are generally in place, but they will need to be strengthened in line with the existing plans or those under preparation.

However, the alignment plans are prepared on an annual basis. Sector specific alignment plans sometimes include the sequencing of the reforms, but this is not necessarily harmonised with the alignment in other areas.³¹¹ As a result, some of the laws have to be amended quite often. The opposition proposed in 2007 the adoption of a multi-annual alignment plan. However, the government considered that such a plan could make negotiations even more complicated and further limit the possibilities for negotiating transition periods.

3.4.4 Programs or ‘road maps’ of developing the national legal system

The government adopted the Strategic Development Framework 2006-2013 in August 2006. This document defines the strategic priorities for economic development and identifies the need for changing the role of the state. Alignment with the *acquis communautaire* is one of the goals of the judicial reform, which is identified as a strategic priority.³¹² According to the Strategic Development Framework, finalising alignment with the *acquis communautaire* should be used not only for the normative convergence of the Croatian legislation in line with the legislation of the EU, but also for a deep transformation of the overall judicial system and its opening towards the application of the useful legal solutions of other states.

The programme of the government for the period 2008-11 also identifies the need for a judicial reform, including alignment with the *acquis*. Concrete measures and annual alignment plans are defined on a yearly basis by the National Programme for the Integration into the EU, which is in line with the Accession Partnership. Also, there is a number of sectorised road maps and action plans identifying the need for the adoption or review of the existing legislation. These include the already mentioned legislation gap analyses, as in the

³¹¹ E.g. the Law on the gas market was adopted in 2001 (*Official Gazette* 68 (1991)). It was planned, at the time, that the Law on concessions will be modernised and changed. As this law was not adopted, the Law on the gas market had to be changed in 2005 (*Official Gazette* no. 87 (2005)), and in 2007 (*Official Gazette* no. 40 (2007)) new changes were introduced to reduce the gap with the EU legislation.

³¹² Government of the Republic of Croatia, *Strategic Development Framework 2006-2013* (Zagreb: Central Office for Development Strategy and Coordination of EU funds, 2006), 71.

field of consumer protection or environmental protection.³¹³ However, there is no comprehensive multi-annual plan identifying the needs for internal harmonisation.

3.4.5 Feasibility analysis

According to the screening reports, Croatia considers that it can accept the *acquis* before the accession in most of the chapters. Furthermore, having in mind the vague timetable for the accession, this view does not provide information about the timetable of the alignment.

Table 3.14 The alignment process, and the number of laws aligned with the *acquis*

	Planned	Adopted	% of plan
2007	55	66	120
2006	59	34	58
2005	44	28	64
2004	45	32	77

The alignment is different from what was planned. The parliament was supposed to align 55 laws with the *acquis* in 2007.³¹⁴ According to the information service of the Croatian parliament, in 2007, 66 European laws were adopted.³¹⁵ This high statistical efficiency, however, does not correspond with the achievements. Namely, the 12 laws that have been identified by the plan (which could be considered as a priority list) have not been adopted. Some of them have been planned since 2004 and have not been adopted yet³¹⁶.

The mistakes in planning were even more evident in 2006, when it was planned to align 59 laws with the EU,³¹⁷ but only 23 laws were aligned. The government claimed that it was not a delay, nor a planning mistake, but a result of the screening process, which indicated different priorities.³¹⁸ Next, the adoption of laws is not sufficient for legal alignment. It was

³¹³ The 'Legislation Gap Analysis' project conducted in 2001 was the first in the process of the harmonisation of the regulations in the competence of the Ministry of Environmental Protection, Physical Planning and Construction, the Ministry of Environmental Protection, Physical Planning and Construction, "The 'Legislation Gap Analysis' project," <http://www.mzopu.hr/default.aspx?id=4293>

³¹⁴ Croatian Parliament, "Alignment plan for 2007," *Official Gazette*, no. 22 (2007), <http://www.nn.hr/clanci/sluzbeno/2007/0819.htm>

³¹⁵ The information service of the Croatian parliament considers laws as being European provided they are adopted by the summary procedure and accompanied by the statement on alignment and table of concordance, <http://www.sabor.hr/Default.aspx?sec=1209>

³¹⁶ E.g. Law on free legal help, Act on regional development and Act on concessions.

³¹⁷ Croatian Parliament, "Alignment plan for 2006," *Official Gazette*, no. 13 (2006), <http://www.nn.hr/clanci/sluzbeno/2006/0322.htm>

³¹⁸ Minister Grabar Kitarović, cited according to Croatian News Agency.

planned that in 2007, together with 53 laws, almost 230 by-laws and 180 implementing measures should be adopted for efficient implementation.

In addition, legal alignment is just a first step in the integration. According to the government's conclusion from 2001,³¹⁹ the Ministry for European Integration should prepare a feasibility analysis for the implementation of each legal act being aligned with the EU. However, such analyses, if they exist, are not publicly available. The government considers that the EU integration as a strategic goal and the accession by 2011 is feasible, but there is no feasibility study on this issue, while the cost-benefit and financial analysis commissioned by the government from the Economic Institute, estimates the economic benefits of the accession based on the assumption that Croatia will become an EU Member State in 2009. As regards the implementation of the *acquis*, the studies conducted so far indicate the number of issues that can limit the implementation of the Stabilisation and Association Agreement (SAA), and the secondary EU legislation in Croatia, which questions the feasibility of the full implementation of the SAA and also poses some legal questions arising from the eventual membership.³²⁰

3.5 EU conditionality

3.5.1 EU conditionality towards Croatia

The EU conditionality towards Croatia was developed in 1995, in the framework of the regional approach³²¹. Croatia was among the "excluded" countries at the time, i.e. it was a country without an Association Agreement. As a result, the economic and political conditions were developed with a view of concluding a Cooperation Agreement, and not as EU membership criteria. Still, the EU conditionality was omnipresent, multi-dimensional and multi-purpose, geared toward reconciliation, reconstruction, and reform. It was regional, sub-regional, bilateral and project specific, relating to a number of economic, political, social and

³¹⁹ Government's Conclusion related to progress in negotiating Stabilisation and Association Agreement, 15.2.2001.

³²⁰ E.g. Siniša Rodin, "Sporazum o stabilizaciji i pridruživanju. Interpretacija i primjena" (presentation available from http://eu.pravo.hr/fileadmin/Europsko/dokumenti/Powerpoint/SSP_01_2004_Rodin.ppt#256,1)

³²¹ Conclusions of the General Affairs Council of October 1995, February and May 1996, the guiding principles of the Civilian Consolidation Plan agreed in Paris in November 1996 and the Conclusions of the London Peace Implementation Conference of December 1996. In this context the Commission presented a strategy paper entitled "The application of conditionality to the development of relations between the EU and the countries concerned by the regional approach", which was welcomed by the General Affairs Council on 24 February 1997.

security-related criteria.³²² The conditionality was also gradual: at the first stage, conditions were focused on the democratisation and stabilisation of the region. The different levels of the relations with the EU (i.e. trade preferences, the extension of financial assistance and economic cooperation, and the establishment of contractual relations) were subject to different degrees of conditionality.

The renewal of autonomous trade preferences was linked to the respect for the fundamental principles of democracy³²³ and human rights³²⁴, and to the readiness of Croatia to allow the development of economic relations with the countries of the region. Assistance for the support of democracy through PHARE was subject to evidence of the country's credible commitment to democratic reforms and progress in compliance with the generally recognised standards of human and minority rights³²⁵. General assistance through this programme required compliance with the obligations under the peace agreements, including those relating to cooperation with the International Tribunal in bringing war criminals to justice. Compliance included an undertaking to make the Federation/Croatia compatible with the General Framework Agreement for Peace (GFAP), under the guidance of the OHR. It also required respect for human and minority rights and the offer of real opportunities to displaced persons and refugees to return to their place of origin. Moreover, Croatia had to undertake a credible commitment to engage in economic reforms,³²⁶ significant steps towards cooperation with its neighbours and the establishment of open relations, including the free movement of people and goods.

³²² C.f. Othon Anastasakis and Dimitar Bechev, "EU Conditionality in South-East Europe: Bringing Commitment to the Process." *European Balkan Observer* 1, no. 2 (2003), 2-4, <http://www.wiiw.ac.at/balkan/files/EBO%202.pdf>

³²³ Democratic principles: 1) Representative government, accountable executive; 2) Government and public authorities to act in a manner consistent with the constitution and the law; 3) Separation of powers (government, administration, judiciary) ; 4) Free and fair elections at reasonable intervals by secret ballot.

³²⁴ Human rights, rule of law: 1) Freedom of expression, including independent media; 2) Right of assembly and demonstration; 3) Right of association; 4) Right to privacy, family, home and correspondence 5) Right to property; 6) Effective means of redress against administrative decisions; 7) Access to courts and right to fair trial; 8) Equality before the law and equal protection by the law; 9) Freedom from inhuman or degrading treatment and arbitrary arrest.

³²⁵ Respect for and protection of minorities: Right to establish and maintain their own educational, cultural and religious institutions, organisations or associations; Adequate opportunities for these minorities to use their own language before courts and public authorities; Adequate protection of refugees and displaced persons returning to areas where they represent an ethnic minority.

³²⁶ Market economy reform : Macroeconomic institutions and policies necessary to ensure a stable economic environment ; Comprehensive liberalisation of prices, trade and current payments ; Setting up of a transparent and stable legal and regulatory framework; De-monopolisation and privatisation of state owned or socially owned enterprises ; Establishment of a competitive and prudently managed banking sector."

However, this conditionality did not function well. The conditions imposed under the regional approach were considered unjust and as an attempt of the international community to impose the regional framework on Croatia³²⁷. The 1998 Conditionality Report stated that the justification of the autonomous trade preferences may be questioned unless Croatia makes progress in relation to the relevant criteria³²⁸. There was also considerable discrepancy between the official statements and the practice on the ground. Until 2000, there was limited progress in relation to a few of the relevant conditions, but it was not sufficient for additional progress in Croatia's relations with the Community.³²⁹

The Stabilisation and Association Process, together with the visible and realistic prospect of membership given to the new government in 2000, enabled the functioning of conditionality. The EU conditionality at that time strengthened and anchored the incentive of national authorities to pursue reforms. It also had an impact on the political process, indicating that the party's entry into the government whose political positions are not compatible with Copenhagen would have negative implications for Croatia's progress towards the EU.³³⁰

The signing of the Stabilisation and Association Agreement, its entry into force and the opening of negotiations were significant steps forward. However, the relatively slow pace of the negotiations, the benchmarks and the delays in the verification process are fuelling cynicism about the EU intentions. The conditions are not seen as steps in a structured process but rather as an instrument for deferring membership. In this respect, the influence of the EU conditionality is decreasing, which can be illustrated by the Glavaš case. Despite the fact that the EU explicitly pointed to the Glavaš case, saying that "the EC expects Croatia to fully

³²⁷ European Commission, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions set out in the Council Conclusions of 29 April 1997; Bosnia-Herzegovina, Croatia, Federal Republic of Yugoslavia, (Brussels, 1997), http://ec.europa.eu/enlargement/pdf/key_documents/9710_report_a_en.pdf

³²⁸ European Commission, Operational conclusions : Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions in the Council Conclusions of 29 April 1997; Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania, COM (1998) 237 final (Brussels, 1998), http://ec.europa.eu/enlargement/pdf/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/com_1998_0237_en.pdf

³²⁹ European Commission, Regional Approach to the countries of South-Eastern Europe: Compliance with the conditions set out in the Council Conclusions of 29 April 1997; Bosnia-Herzegovina, Croatia, Federal Republic of Yugoslavia COM(1998) 618 final (Brussels, 1998), http://ec.europa.eu/enlargement/pdf/enlargement_process/accession_process/how_does_a_country_join_the_eu/sap/comm_pdf_com_1998_0618_f_acte_en.pdf

³³⁰ Italy, in its capacity of the EU presidency, expressed concerns regarding the possibility that the Croatian Party of Right (HSP) enter into the government following the 2004 elections. Slobodna Dalmacija, Daily, 16.12.2003., interview with Alessandro Grafini, "Veleposlanik Italije i predstavnik EU-a u Hrvatskoj", <http://www.hsp1861.hr/vijesti4/031216ss.htm>

respect due procedure, independence of the judiciary and rule of law, in this, as well as all other cases”, the parliament enabled Glavaš’ release.³³¹

The issue of the Ecological and Fisheries Protection Zone was seen as a major obstacle for Croatia’s integration into the EU at the beginning of 2008 (January-March). Immediately after the suspension of the Zone, the President of the European Commission, Jose Manuel Barroso, signalled that Croatia should be able to conclude the EU membership talks by the end of the mandate of the Commission (in November 2009). He also confirmed that the 2008 Enlargement Package (which is to be published in the autumn of 2008), will contain an indicative timetable for the technical conclusion of the negotiations in 2009, provided a number of conditions are met by Croatia. The first condition that needs to be fulfilled relates to Croatia’s meeting all opening benchmarks by June 2008 (i.e. in eleven negotiation chapters 23 benchmarks are to be met). Secondly, Croatia must comply with all legal obligations under the Stabilisation and Association Agreement (SAA), and it must continue to comply with the general conditionalities of the Stabilisation and Association Process. Furthermore, Croatia urgently needs to improve its management of the EU financial assistance under the PHARE and IPA programmes, while the forth criterion for presenting a roadmap has already been met. That is, Croatia suspended all aspects of the Ecological and Fisheries Protection Zone, with respect to EU vessels³³².

3.5.2 The internalization of social, political and economic rules

The main EU principles, such as liberty, democracy and respect for human rights, fundamental freedoms and the rule of law, as well as fundamental social rights and values (pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men) are accepted as objectives for Croatia. The fulfilment of the Copenhagen political, economic and legal-institutional criteria would mean that Croatia has reached the goals of a modern, capable and open society. In that sense, the social, political and economic rules exerted by the EU are internalized in Croatia. Still, when it comes to more specific issues, overreaching reforms which can be painful (e.g. the reform of the social security system,

³³¹ Branimir Glavaš was indicted for war crimes. As he was elected MP, he got new immunity. The parliament allowed continuing the investigation, but it decided that he has to be released, which questions the separation of power between the judiciary and the parliament.

³³² Speaking points of Commission President José Manuel Barroso during the press point, following his meeting with Croatian Prime Minister Ivo Sanader, available from http://www.vlada.hr/en/naslovnica/novosti_i_najave/2008/ozujak/predsjednik_vlade_s_predsjednikom_europske_komisije_barrosom, accessed on 1 April 2008

labour law) the readiness for implementation becomes a challenge. This is not necessarily related to the readiness to accept the EU rules, but with the readiness to accept and implement the remaining transition-related reforms or to adapt to the globalisation process. Studies³³³ indicate the need for the readiness of citizens to support the changes and the willingness of politicians to undertake the risk, plus a public administration capable of first reforming itself. As comparable resistance also exists in the EU Member States (e.g. concerning services directive or the liberalisation of the energy markets), it can be concluded that the core social, political and economic rules are mostly internalised.

The EU's tailor-made conditions are supposed to be formulated in order to judge each country on its own merits. They are generally considered as social, political or economic rules that are common to the EU Member States, but some of these tailor-made conditions might be inadequate, or not well communicated, and thus, not internalised. The Croatian Ecological and Fisheries Protection Zone and the Gotovina case represent such conditions.

The Ecological and Fisheries Protection Zone, according to the publicly available arguments, seems to be an inadequate condition: the regime of the Zone has been in force for over three years, but it has not been applied to the EU Member States, as agreed at the Brussels trilateral meeting in June 2004. However, all Croatia's calls to conclude a fisheries partnership agreement with the EC have remained unanswered.

In 2005 and 2006, respectively, Slovenia and Italy proclaimed their ecological zones in the Adriatic without prior consultations among the neighbours, and in autumn 2006, the opening of the negotiations of Chapter 13 (Fisheries) - under which the issues related to Zone implementation could have been discussed - remained blocked in the Council by one Member State (Slovenia). At the end of 2006, the *acquis* concerning sustainable fisheries management in the Mediterranean developed further and a new regulation was adopted by the Council, explicitly referring to the "Member States fishing zone". As the Zone shall become part of the Community waters after Croatia's accession, the efforts to promote and protect this Zone even before the accession to the EU seem to be in the best interest of the Union as a whole. The suspension of the negotiations can be thus regarded as a lack of the EU's genuine interest to integrate Croatia and as an attempt of the protection of the economic interest of a couple of Member States.

³³³For instance, Katarina Ott, "Croatian accession to the European Union: the challenges of participation," in *Croatian Accession to the European Union: The Challenges of Participation*, ed. Katarina Ott (Zagreb: Institute of Public Finance: Friedrich Ebert Stiftung, 2006), 1-4, <http://www.ijf.hr/eng/EU4/ott.pdf>

On the other side, the issue of cooperation with the ICTY in the Gotovina case represents a lack of internalisation, since the war crime suspect was considered to be a national hero. In addition, the condition imposed on Croatia to “locate, arrest and extradite” was perceived as inadequate, especially after he was arrested in Spain. Such cases undermine the EU’s credibility and consequently, they can diminish the influence of the enlargement conditionality, which is considered to be one of the EU’s most powerful policy tools.

3.5.3 Croatia’s accession date

It is expected that Croatia is likely to become the next (i.e. the 28th) EU Member State. It is not likely that it will become a member before 2011, but it is extremely difficult to estimate when the accession is likely to occur. In 2002, the Croatian government’s target date for meeting the membership criteria was 2006³³⁴. In 2005, the Croatian parliament adopted the Resolution on the Principles governing the negotiations, which stipulates the intention to be ready for membership in 2007.³³⁵ In 2006, the government commissioned a cost-benefit analysis of the membership, based on the assumption that Croatia will enter the EU in 2009. According to the government’s programme, Croatia should enter the EU in this term of the office, i.e. by 2011 at the very latest.

The projections of the EU are less optimistic, and in late 2005, the EU officials projected that Croatia’s accession would likely happen between 2010 and 2012. In October 2006, Commissioner Olli Rehn stated that Croatia is likely to be ready for EU membership by 2010, provided it reforms its judiciary and economy with rigour and resolution. In March 2008, the President of the Commission stated that Croatia will be able to meet the conditions which are required by the Commission in order to set out a conditional roadmap in the autumn of 2008, with a view to conclude the technical negotiations in 2009, preferably by the end of the mandate of the Commission.

The above-mentioned estimates are based on Croatia’s merits and alignment with the EU membership criteria. It is assumed that the EU will solve its internal issues and enable further enlargement. The signing of the Reform Treaty is also regarded as a step towards Croatia’s membership. The Croatian government considers it feasible that the Treaty will be ratified in the national parliaments by the beginning of 2009, which would allow its entering

³³⁴ E.g. Vlada Republike Hrvatske, 2002, na str III, for more about this see Ana-Maria Boromisa, “Uključivanje Hrvatske u EU: retorika ili realnost,” in *Odnos države i tržišta na putu integracije Hrvatske u svjetske gospodarske tokove*, ed. Ahec- Šonje, Babić, Bibić (Zagreb: Friedrich Naumann Stiftung, 2003).

³³⁵ Parliament, 2005

into force before the European Parliament elections in 2009. This timetable is in line with the government's expectations to finalise negotiations in 2008, and that the accession treaty can be concluded in time for the European Parliament to give its consent before the next EU parliamentary elections in June 2009. Considering that the ratification process in the member countries cannot start until the European Parliament gives its consent, Croatia could lose 6 to 9 months.

In sum, the fast inclusion scenario is that Croatia finalises negotiations in 2008 or in early 2009, and that the European Parliament ratifies the accession treaty in the first half of 2009. A fast ratification in 27 Member States should enable full membership in 2011. However, the latest developments suggest that it is not very likely that Croatia could meet such deadlines, especially having in mind the scope of the reforms needed (in the judicial and administrative reforms, fighting corruption and restructuring the shipbuilding sector), as well as recent temporary suspension of the EU's financial support to Croatia. Next, the Reform Treaty, once ratified, will provide a framework for the participation of the representatives of the new Member States in the EU institutions. As the power of each individual Member State will change with each enlargement, the institutional setting should be fine-tuned before each enlargement.³³⁶ Thus, difficulties in drafting the accession treaty might arise and cause some delays in Croatia's accession and enable the catching-up of other candidates and potential candidates. This would mean slowing down Croatia's accession process and speeding up that of the other candidates and potential candidates.

3.5.4 Conditionality and development

The EU conditionality, strengthened by benchmarks as a new instrument in the accession process, in its substance should assist a country to identify and meet the specific targets, and as such serves as an important measuring stick. In principle, conditionality can be considered as a useful instrument for the promotion of social, political and economic development. On the one hand, the conditionality can add to the credibility of the accession process and facilitate the ratification of the accession treaty in the EU Member States. On the other hand, there is a danger of misusing the conditions as a means to prolong, bloc or filibuster the accession process.

³³⁶ For more, see Ana-Maria Boromisa, "Western Balkans' European Perspective and EU's absorption capacity," in *Economic integration, competition and cooperation*, ed. Vinko Kandžija and Andrej Kumar (Rijeka: Ekonomski fakultet Rijeka, 2007).

The general conditions, such as those requiring a reform of the judiciary, the reform of the public administration, the protection of the minorities, the fight against corruption, cooperation with ICTY, refugee return, and the development of good neighbourly relations, are likely to play a positive role in the next period. The efficient implementation of the required norms, and thus, the EU conditionality will play a positive role in promoting social, political and economic development in the next 10 years. The EU's role is likely to be stronger if Croatia is close to entering the EU. Delays as well as specific cases, such as the Croatian Ecological and Fisheries Protection Zone, or the suspension of financial assistance might undermine the credibility of the EU, and thus, the readiness to meet the conditions.

Acceptance of the EU conditions as internal norms can be considered as one of the major achievements of the transition process and a decisive step forward in promoting development. The changing perception of the EU's role, from a supreme authority and a solution to the inherited problems to a partner can serve as an indication of the catching-up. At the point when the benefits of the reforms become visible, regardless of the EU membership, the conditionality becomes obsolete.

3.6 Divergence or convergence to EU norms after the accession

The negotiation process has become more rigorous and technically complex, in particular due to the formalised opening and closing benchmarks. Benchmarks represent a novelty in the process and provide for the implementation and not merely the adoption of the *acquis*. In this respect, it is likely that the transitional periods following Croatia's EU entry will be even more limited in scope and duration than in the previous round of enlargement. Next, conditionality is seen as an evolutionary process, i.e. at each stage, including the one after the conclusion of the agreements, the situation can be monitored, and, in accordance with the relevant articles of the agreement, its application could be suspended in case of serious non-compliance.

Safeguard clauses and verification instruments are likely to be applied in Croatia's accession treaty. Such clauses can build on the experience of the last round of enlargement. The delays applied for Bulgaria and Romania can be strengthened with suspension clauses, and thus, conditionality can be regarded as an evolving process,³³⁷ which is gradually being

³³⁷ C.f. Ian Barnes and Claire Randerson, "EU enlargement and the effectiveness of conditionality: keeping to the deal," in *Managerial Law* 48, no. 4 (2006), 351-365, <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/0100480401.html>

extended to the post-accession phase. Also, benchmarking should ensure that the transformative effect of the accession process has been achieved.³³⁸ Further, the EU introduces new tools for all Member States, not only for a new one. These include progress monitoring and defining country-specific recommendations, as in the new “Lisbon package” presented by the Commission in December 2007. Conditionality and the new EU instruments should ensure that membership does not differ from pre-membership as regards the compliance to the rules.

Problems might arise with soft-law or the compromise culture of the EU. The examples of such behaviour include Poland regarding the EU energy policy (and relations with Russia), or Slovenia regarding the Ecological and Fisheries Protection Zone, thus making accession negotiations slower. On the other hand, such behaviour can be regarded as steps towards taking an active role in shaping community-level policy, comparable with role of Poland and Lithuania in shaping the EU’s relations with Ukraine.. It can be argued that the success of integration might be evaluated not merely as adherence to the EU norms and reducing the differences between the old and new countries, but also as active participation in policy making, which to a certain (albeit limited) extent might diverge from a compromise culture. Thus, successful integration would mean convergence with the EU norms at the level comparable with Member States, old and new ones.

³³⁸ C.f. Heather Grabbe, “The Process of EU Accession: What will it bring to Southeast Europe?,” (2003), http://www.wiiw.ac.at/balkan/files/GDN_EU_Grabbe_EUaccessionprocess.pdf

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