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Economic and legal challenges

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FOREWORD

Croatia is preparing for EU membership in 2007. Since signing the *Stability and Association Agreement* (SAA) in October 2001 Croatian policy has put a strong emphasis on activities to meet the demands of the SAA and to achieve the ambitious goal of becoming a candidate country in a relatively short time. In this context the Friedrich Ebert Stiftung and the Institute of Public Finance in Zagreb initiated a project to monitor and to evaluate the EU accession process of Croatia by Croatian researchers. Although there are regular official reports on the progress of the implementation of reforms in Croatia by the government and international organisations we launched this project, because we deem it important to present a critical view of independent domestic experts on the accession process covering political, economic and social aspects. The EU Monitoring project has been given the task of watching and analysing the accession process during the years to and producing annual reports on the development of Croatian society in the EU accession process.

It is from this point of view that the project attempts to analyse deficits and problems as well as the progress in the development of the reform programs aimed at meeting the requirements of SAA and EU standards in general. This analysis should lead to the elaboration and formulation of alternative approaches or eventually to policy recommendations. The main objective of the whole project is to present the results of this work to the interested public and to create an impetus for public discussion. One important target group in this sense is of course the group of decision makers at different levels of society in the government, economy and public administration. But apart from them it is necessary as well to address representatives of organisations and groups in the sector of civil society, as reforms in preparing the country for EU membership concern and challenge all parts of the society. To date, a large majority in Croatia has supported the aim of joining the European Union.

To start the project we organized a workshop in Zagreb at the end of March 2002 gathering interested researchers and potential authors for the study to reflect on the concept of the project and discuss the priorities to be covered. Furthermore, we invited two researchers from Poland and Bulgaria, who are participating in similar projects in their countries, to report on their approaches and experiences. Last but not least, at this stage of the project we also asked representatives of

the Ministry of European Integration to take part in the discussion of priority areas as seen by their Ministry. As a result of this workshop a team of authors agreed to prepare papers on the identified priority areas and along common guidelines.

The studies presented in this book give the reader an insight into the situation and problems of different areas in Croatian society and their political approaches to the implementation of reform programs in preparing the country for EU membership. The book concentrates on economy, legislation, and civil society issues. By this selection we think we have chosen some of the most important areas in the context of EU accession at the present time. We hope to contribute by this work to the efforts of Croatia to implement the necessary reforms and thus smoothing the way to the European Union.

Finally, I would like to thank all those who participated in this project, particularly Dr. Katarina Ott, director of the Institute of Public Finance and editor of the volume, as well as Prof. Dr. Nenad Zakošek, for assisting in editing the contributions.

Zagreb, November 2002

Dr. Rüdiger Pintar
Friedrich Ebert Stiftung
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On behalf on the Institute of Public Finance, and also personally, I would like to thank our friends from the Friedrich Ebert Foundation, particularly Rüdiger Pintar and Nenad Zakošek, who first of all encouraged us to deal with monitoring Croatian accession to the European Union, and then also financed our work.

Thanks to this complex and interesting project, lawyers, agronomists, economists and engineers found themselves involved in a common venture and without a doubt learned a great deal from each other.

I would like to thank all those who took part in the project, particularly the authors of the chapters in the book, for the work they have put in. And thank you too to the anonymous referees of all the papers, who most certainly contributed to the quality of the writing.

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Finally, I wish to thank employees of the Institute of Public Finance, particularly Ivica Urban, Pava Turudija and Martina Matejčić for their dedicated work, without which this book could not have been produced.

Katarina Ott
Editor

ABBREVIATIONS

BIS	Bank for International Settlements
CAD	Common Administrative Document
CAF	Charities Aid Foundation
CAP	Common Agriculture Policy
CARDS programme	Community Assistance for Reconstruction, Development and Stabilisation
CBS	Croatian Bureau of Statistics
CEE	Central and East European Countries
CEFTA	Central Europe Free Trade Agreement
CES	Croatian Employment Service
CNB	Croatian National Bank
CONNECS	Consultation, European Commission and Civil Society
COREPER	Committee of Permanent Representatives of Member States
DRC	Domestic Resource Cost
EBRD	European Bank for Reconstruction and Development
EC	European Community
EC	European Convention/European Commission
ECAS	European Citizens Action Service
ECB	European Central Bank
EEA	European Economic Area
EEC	European Economic Community
EES	European Employment Strategy
EFTA	European Free Trade Association

EMS	European Monetary System
EMU	Economic and Monetary Union
EPR	Effective Protection Rate
ERA	Effective Rate of Assistance
ERM	Exchange Rate Mechanism
EU	European Union
Eurostat	Statistical Office of the European Commission
EWPPP	East West Parliamentary Practice Project
FED	Federal Reserve Board
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GIPS	Global Investment Performance Standard
GSP	General System of Preferences
HAC	Croatian Motorways
HBOR	Croatian Bank for Reconstruction and Development [CBRD]
HEP	Croatian Electrical Company
HGA	Croatian Guarantee Agency
HRK	hrvatska kuna (Croatian currency)
HRN	Croatian Norm
HZZO	Croatian Institute for Health Insurance
IAPM	Interactive Policy-Making Initiative
ICTY	International Criminal Tribunal for the former Yugoslavia
ILO	International Labour Organization

IMF	International Monetary Fund
ISO	International Organization for Standardization
JCD	Common Administrative Document
LDC	Least Developed Countries
Lomé	ACP Countries (Africa, Caribbean, Pacific)
MEI	Ministry of European Integration
MFN	Most Favoured Nation
MMF	International Monetary Fund
MOMSP	Ministry of Trades, Small, and Medium-Sized Enterprises
MOR	International Labour Organization
NGO	Non-Governmental Organization
NPR	Nominal Protection Rate
OECD	Organisation for Economic Co-operation and Development
PHARE programme	Pologne-Hongrie: assistance à la restructuration économique
SAA	Stabilization and Association Agreement
SAPARD	Special Accession Programme for Agriculture and Rural Development
SOZM	State Office for Standardization and Metrology
TRIPs	Trade Related Intellectual Property Rights
UCTE	Union for the Co-ordination of Transmission of Electricity
WTO	World Trade Organization

Chapter 1

CROATIAN ACCESSION TO THE EUROPEAN UNION

Economic and legal challenges

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There are two types of society: closed societies and open ... When we use the word democracy we do not or should not mean any particular form of political structure; such matters are secondary. What we mean or ought to mean is the completely open society... We may not know very much, but we do know something... and while we must always be prepared to change our minds, we must act as best we can in the light of what we do know.
(W. H. Auden, 1940, Criticism in a Mass Society)

ABSTRACT

This chapter aims to summarise and analyse the project that involves the work of a group of experts whose ambition it is to help those who make the political decisions, the media and interested readers to understand the requirements of the EU and the situation in Croatia, to draw concrete conclusions and make recommendations for essential measures. Part one raises the question of whether the EU is fiction or reality, part two puts Croatia in the context of the EU, while the third part concentrates on macroeconomics, banking and finances, taxes, government aid, trade policy, power, agriculture, employment and unemployment, the legal system, the non-governmental sector and

equality between men and women. Part four analyses key questions of Croatia's accession to the EU – regulation within the EU itself, the normative and real harmonisation of Croatia and the EU, Croatian advantages and its points of vulnerability, and a comparison of Croatia with member countries and candidate countries. The chapter also offers a number of recommendations for individual areas, while particular stress is placed upon recommendations that relate to the importance of the public administration and the independent agencies, the question of whether it is better to make adjustments at once or only when they are essential, and the attitude to regional initiatives. The message of the paper is that most of the criteria of Maastricht, Copenhagen and the Stabilisation and Association Agreement are posed in such a way that they can only be of benefit to the country. Our goal ought to be to live in a society that meets as many of these criteria as possible, and whether Croatia will, in so doing, be a member of the EU or of some other association, or an association with some other name that will be relevant at the time Croatia has achieved all this is less important. The EU may help Croatia in its economic and social development, but only the citizens of Croatia can achieve economic development, institutions that are more efficient, and a society that is going to respect the laws and the rights of individuals.

Key words:
European Union, Croatia, economic and legal adjustment

INTRODUCTION

The objective of this chapter is to show the working of a group of people of various specialities gathered together in the Croatian accession to the EU project. We would like to be able to help the makers of political decisions, the media and other interested readers in understanding the requirements of the EU and the situation as it is in Croatia and to propose concrete conclusions and recommendations of necessary measures. We have focused on certain, in our opinion interesting and crucial, areas – macroeconomics, banking and finance, taxes, state aid, trade policy, energy, agriculture, employment, the legal system, the non-governmental sector and equality between men and women. Since this is a long-term project, in the coming years we shall renew and update our knowledge about some areas worked on this year, and also bring in certain new

topics. Our aim is in time to identify the most important areas in which the expectations and the real state of affairs diverge the most, and in which we might be able to contribute to the quality of public debate and, in the end, to Croatia's accession to the EU.

With a few divergences, each one of the chapters in this book is composed in more or less the same way. First of all the conditions for the accession of new members are analysed, that is, the basic framework that the EU has set for future members is put forward, for this is the goal to which Croatia needs to strive. In the second part, whenever it is possible, the condition in Croatia is compared with the state of affairs in selected other countries. Then the initial state of affairs in Croatia on the road towards the EU is determined, that is, an estimate is made of how much Croatia is lagging behind, or whether it has any initial advantage with respect to the criteria for membership in the EU. Then there is an endeavour to determine the realistic degree of stability and the main limitations which could stand in the way of Croatia's attaining the set objectives. At the end, we endeavour to draw concrete conclusions and recommendations of measures necessary for a fairly rapid adaptation of Croatia to the standards for membership in the EU.

We have attempted to write in as popular a way as possible, keeping in mind the well-informed and educated reader who is nevertheless not an expert in the area concerned. In addition, we have not adhered blindly to the currently set requirements of the EU; rather, according to our own research and understandings, we have drawn attention to any Croatian weaknesses and advantages there might be. In so doing, we have endeavoured to ignore current political problems (such as the relation with the ICTY, dangers of sanctions and so on), for these problems will inevitably be settled in the course of time, while the essential structural problems will remain, and it is with them that we shall have, sooner or later, to come to terms, irrespective of any accession to the EU. The Union may help Croatia in its economic and social development, but only the citizens of Croatia can make sure of continued economic growth, more effective institutions and a society capable of respecting both laws and the rights of the individual.

After the introduction, the first part of this chapter makes a brief reference to the EU, while the second puts Croatia in the context of the EU, and the third describes the economic and legal aspects of Croatian joining of the EU according to topics and authors, while the fourth deals problematically with the key questions of Croatian convergence with the EU; at the end comes a conclusion. This chapter is written with the objective of acquainting the reader with the contents of the

book as a whole and to encourage him or her to read the sections that are of particular interest. As a result of an approach of this kind, the text does have certain repetitions, but then, the whole of the book does not need to be read, nor does the whole of this chapter. Readers can simply opt for given sections or topics.

THE EU – FICTION OR REALITY

We can start this chapter with a very simple table that paints the relative and absolute significance of Croatia and the EU. The area of Croatia occupies a mere 4.5% of the area of EU, its population is only a bit more than 1% of the EU population, the Croatian GDP is only 0.25% of the EU and Croatia's per capita GDP is only 21% of that in the EU. These are figures that we should constantly bear in mind.

Table 1 Comparison of Croatia and the EU

	Area (000 km^2)	Population (million)	GDP (billion USD)	Per capita GDP (000 USD)
Croatia	56.5	4.4	19.5	4.4
EU-15	1,249.0	378.0	7,894.5	20.9
Croatia/EU (%)	4.5	1.1	0.2	21.2

Source: DZS, EUROSTAT

The area covered by today's EU has in the last fifty years passed through a number of phases, starting from irrepressible optimism and the feeling in the 1950s that everything was possible, moving to concern, vacillation and weighing of the costs and benefits in the nineties. Countries interested in EU membership today have to face many problems. The basic problem is the hesitation of the members because of financial reasons, particularly because of the vast amounts that the EU spends every year on regional and agricultural assistance. Secondly, a very large problem is the rise in the influence of populist parties (for example, in France, Austria, Holland and Denmark) which are panicking about a possible flood of immigrants from the poorer parts of Europe. Apart from that, the administrative obstacles are such that applicant countries have to adopt and apply more than eighty thousand pages of EU law. However, according to Gallup polls, more than 60% of EU citizens today support the enlargement of the EU. The only exceptions to this are Finland, Sweden and the UK.[i]

In principle, every European country that meets the conditions may become a member of the EU, the decision being made by the Council of Ministers and the European Parliament. These conditions relate to the principles of freedom, democracy, respect for human rights and fundamental liberties, and the rule of law. In the Copenhagen criteria, adopted in 1993 for the sake of the countries of Central and Eastern Europe (CEE), democracy, the rule of law, respect for human rights and protection of minorities, a functioning market economy and respect for the criteria of political, economic and monetary union were particularly stressed. The Copenhagen criteria relate to the development of the fundamental political, administrative and judicial institutions, their aim being the creation of the conditions for the adjustment of the CEE countries to the institutional structure of the EU in as short a time as possible (for more about the Copenhagen criteria, Mihaljek[ii]).

During the long history of the EU, new members have joined in various manners (for more about procedure, Rodin). In more recent times, the first step has been making an association agreement for an unspecified period of time. The association treaties are entered into between the EU (the Council and the Parliament) and the member states, and have to be ratified by all states members. The performance of the obligations defined in the treaties is monitored by the Commission and the Council, which publish their reports. If everything is in order, the next step is that the associated states submit applications for full membership. It does not have to be like this though. For example, since 1963, Turkey, not from its own free will, has kept the status of associate member, and Iceland and Norway do not wish to take this step, and are more satisfied with associate membership in order to be able to protect their own interest (Iceland its fisheries, Norway its oil) (for more about exceptions, Bartlett[iii]).

After an associate member has submitted its application for full membership, an accession partnership is entered into, defining the relation with a given applicant country and helping it to attain full membership. The final act is the change of the founding treaty, that is, constitutional changes in the EU in response to an accession treaty with the EU candidate country. Treaties have to be ratified by the EU and the national parliaments of all the members. The procedure is obviously very long, and there is no guarantee at all that one phase will come after another.

Candidate countries must adopt and apply the legal patrimony of the EU, the *acquis communautaire*. The acquis has 31 chapters, ranging from free movement of goods, persons and services, via taxation, statistics, culture and audiovisual policy, to finances and budgets.

In negotiations about adoption of the acquis there is a fair amount of leeway allowed, and individual legislative approaches can be adapted to specific interests. How much, during the taking on of the acquis, individual solutions will correspond to the interests of the candidate country depends on the expertise and capacity of the administration in its negotiations with the EU. Candidate countries adopt a national programme for implementing the acquis, and the EU monitors this implementation. For the time being Lithuania has agreed on the most chapters (28), Romania on the fewest (12). The EU provides pre-accession aid for meeting the requirements of the acquis (for more about the acquis, Mihaljek). Alas, the acquis is extremely complex and is becoming more and more complex day by day. As Bartlett points out (2002), it includes essential and crucial regulations, as well as entirely trivial rules. A particular problem resides in the many requirements that although desirable (ecological, for instance) and possibly very appropriate to highly developed economies are at the same time very expensive for poor countries, even unsuitable for the conditions and habits of some states. Nevertheless, it is assumed that the beneficial elements of the acquis will prevail, and that they will lead us in a correct long-term journey, irrespective of whether a country can join or intends to join the EU or not.

The EU association and membership process, although very complex, is not impossible to describe. However, it is very difficult to say something about the duration of this long and complex road. For quite a long time it has been expected that the first CEE countries will become EU members before elections for the European Parliament in 2004 but not even now, at the end of 2002, is it known with any certainty whether this will really happen, and if so, when. The only thing that is certain is that the number of such countries will be smaller than previously expected, and that Bulgaria and Romania have definitely dropped out of the running in the meantime. Of the CEE countries, at the moment Poland, Hungary, the Czech Republic, Slovakia and Slovenia are candidates. It is a very unrewarding activity to speculate about the possible data of Croatian entry. Eurosceptics, and we might well call them Eurorealists, do not believe this will occur in the first decade of this century. Of course, there are also more optimistic estimates, but it is not possible to say how realistic they are.

Vaclav Klaus[iv], for example, is very sceptical when it comes to the rapid entry of a large number of new countries into the EU. In his view, the EU is not a charity organisation, which wishes to have as many new members as possible, but a cartel of countries with very well

defined interests. It is in the interest of the EU to extend the provisional status of applicant countries as long as possible, and in the interest of the applicant countries to be members as soon as possible. If the cost-benefit curves of member countries and applicant countries are looked at for the period after 1990, we shall see that the member countries have already used up most of the benefit that they can obtain from the applicant countries. The citizens of the EU are already in these countries. They are in Zagreb and Prague in the roles of tourists, merchants and bankers. The countries of the EU have already achieved almost all their objectives and cannot derive any more considerable benefit from the further process of convergence. In graphic terms, the difference between the member country benefit curve and the applicant country benefit curve is greatest in about 2000, and it is in the interest of the member countries to prolong this state of affairs as long as possible. Mencinger (2002)[v] speaks, in a similar context, of the hypocrisy of the EU, first of all inviting us, and now no longer wanting us.

Naturally, as with every topic, there are various views about EU accession, opposed views, from the Eurosceptics, who expect almost nothing, to the Eurooptimists, who think that joining the EU will solve all, or almost all, the problems of the transitional countries. Nevertheless, the Maastricht criteria, the Copenhagen criteria, most of the Stabilisation and Association Agreement (SAA) provisions are framed in such a way that they can only be of benefit to any country. It ought to be the aim of all of us to live in a society that meets as many of these criteria as possible, and whether we will the while become members of the EU or some other association or an association with some other name that will exist when we actually achieve all this is less important.

CROATIA ON THE ROAD TO THE EU

The former socialist countries of CEE started the process of converging with the EU at the beginning, or in the middle, of the nineties. Croatia, unluckily, first of all because of the war, and then because of the unpopularity of the HDZ regime and President Franjo Tuđman, lost practically a whole decade on this journey. This falling behind has harmed Croatia in many areas such as science and education but, looked at economically, has been particularly detrimental to foreign trade (see Boromisa and Mikić; Bartlett, 2002).

As against the Europe Agreements that were made with the current applicant countries (CEE countries), in 1999 the EU adopted the Stabilisation and Association Process for the countries of SE Europe, i.e., for Croatia, BH, Macedonia, Albania and the FRY. This process is put into practice by the making of individual agreements with these countries. So far SAAs have been signed by Macedonia and Croatia. Unlike the Europe Agreements, these agreements contain an evolutionary clause and provisions about regional cooperation. Apart from that, while the Europe Agreements expressly mention that the basic objective is the integration of the countries of CEE into the EU, the SAAs speak about potential candidates for members of the EU, making this conditional not only on the Copenhagen criteria but also on the regional cooperation already mentioned.

Croatia signed its SAA with the EU in Luxembourg on the 29th of October 2001 and thus became a potential candidate for the EU. The SAA was to be ratified by the Croatian Parliament, the European Parliament and the parliaments of all EU members. By summer 2002 this had been done by the Croatian and European parliaments, as well as those of Austria, Denmark and Ireland. Until the SAA comes into force, which in some optimistic forecasts could be in about two years, an interim agreement is in force, since 1 January 2002. The First Report of the European Commission about the process in Croatia, dated 4 April 2002, is mainly positive. The report speaks of the meeting of the political criteria – strengthening of democracy and the rule of law, respect for human rights and the protection of minorities, as well as regional cooperation. The report has doubts about the situation in the judiciary, and priorities that need to be tackled in the next year are given (see Rodin).

In order to execute the obligations deriving from the SAA, the government has accepted the Implementation Plan of the Agreement, and should publish monthly reports about the results. Although there has been an endeavour to carry through numerous measures (of the 128 measures, 65 were carried out in time), there are obvious delays in the areas of minority protection, reform of justice (see Rodin), television, state aid (see Kesner-Škreb and Mikić) and consumer protection.

Since the SAA calls upon Croatia to take part in the process of regional cooperation with the countries of SEE, in the Croatian public, and in political circles as well, it has been greeted with a fair

amount of scepticism, indeed with resistance. The SAA constantly raises the doubt about whether Croatia should or could go into the association process on its own or part of a West Balkan package. Mihaljek, for example, says that in the SAA, as against the often expressed opinions that it is thrusting us into this group, there is a clearly expressed individual character in the convergence of Croatia with the EU. As the necessary grounds for making the transition from status of potential candidate to that of full candidate for EU membership and for further negotiations about full membership, the individual capacity of Croatia to make the legal, economic and political adjustments, as well as its readiness to contribute to regional cooperation and stability in South East Europe, will be considered.

It is a fact that more than three quarters of Croatian citizens have a positive opinion about the EU and support Croatian efforts to enter the EU.[vi] How much the citizens are at the same time aware of the benefits and costs of joining the EU, and how much this is simply an impressionist view of things brought about by the general climate, the influence of the media, the discontent with current conditions and the desire for a change is not really essential at this moment. It is essential that Croatia, even without EU pressures, has to launch and carry out many reforms. And these reforms will be the more successful the earlier and better we carry them out, fully aware that they are really necessary to us, and are not just being forced up on us. This book should make a contribution to the maturing of such viewpoints.

ECONOMIC AND LEGAL ASPECTS OF CROATIA'S ASSOCIATION WITH THE EU

In this part we shall briefly outline the views of the authors of this book on certain economic and legal aspects of Croatia's joining of the EU – macroeconomics, banking and finance, taxes, state aid, trade policy, energy, agriculture, employment, the legal system, the non-governmental sector and equality between men and women.

Macroeconomics

Dubravko Mihaljek analyses the economic criteria for membership in the EU and the European Monetary Union (EMU), attempting to compare the starting position of Croatia with that of other CEE countries. He concludes that Croatia does not lag behind the other countries in CEE and that it even has a certain advantage with respect to the main macroeconomic criteria (except for the budget deficit), efficacy of investment and potential growth. However, the lag in certain important microeconomic areas – the securities market and the policy of market competition, is estimated at almost four years of systematic reform efforts. For this reason it is necessary to persist in the implementation of reforms and run economic policy very circumspectly.

Banking and finance

In connection with most of the criteria relating to banking and finance, Velimir Šonje concludes that Croatia has the character of an advanced country. A more considerable lag is observed in the area of the development of the capital market and openness to international financial flows, which in the future could turn out to be serious sources of vulnerability in the process of joining the EU.

Taxation

Hrvoje Arbutina, Danijela Kuliš and Mihaela Pitarević conclude that the Croatian tax system is comparable with those of the members of the EU. The key difference is the considerably greater tax burden in Croatia than in the EU, relating, however, to contributions, which have to be gradually reduced, as the situation allows. All the essential taxes conceptually correspond to the same kind of taxes in the countries of the EU. Nevertheless, it is desirable to carry out certain adjustments to VAT as soon as possible, while the harmonisation of profit tax and of some excise taxes should be postponed until the moment when it becomes unavoidable because of accession to the EU. The maintenance of the current situation in the area of these taxes is not in line with the provisions of European tax regulations, but it is nevertheless in Croatia's interest.

State aid

Marina Kesner-Škreb and Mia Mikić point out that in the EU it is considered that state aid distorts market competition and that it is a limiting factor in the functioning and development of the single market. The European Commission has the right to ban any state aid that distorts market competition by extending privileges to certain firms and sectors. In Croatia, government expenditure to promote the economy is considerable and mainly directed towards certain sectors: shipbuilding, tourism, transport and agriculture. Croatia will be able to use state aid in the future, but will gradually have to reduce it and redirect towards horizontal targets.

Trade policy

Ana-Maria Boromisa and Mia Mikić state that during the transition period the reforms necessary for joining the EU were not carried out and that progress is slower than in the candidate countries. Croatia did, however, start the EU convergence process at a higher level of development than a number of other potential members, and the lag in the preparations for membership has not totally destroyed Croatia's initial advantages. It is a question, however, whether these advantages will not perhaps completely disappear in the first phase of the next expansion of the EU.

Energy

Although the legal system in Croatia is very largely harmonised with the EU system, Ana-Maria Boromisa claims that the process of converging on the EU in the area of energy cannot be considered a success, because practice, that is, the manner in which the rules are interpreted and ultimately implemented, is developing in the opposite direction from the principles set up by the EU. Since the laws assume their final shape in the course of their application, and since it is much more difficult to change the way the rules are interpreted and implemented, particular attention needs to be devoted to practice during the harmonisation process.

Agriculture

Ramona Franić and Tito Žimbrek point out that Croatian agriculture is behind that of the member countries. Since the signing of the SAA, the situation has been constantly improving, but Croatia will have to accept the liberalisation of EU-origin products and yet attempt to retain certain privileges. What is crucial is to improve the competitiveness of domestic agriculture, while making sure to preserve domestic natural resources. The harmonisation of the legislation is essential, but this technical task is less of a problem than the accommodation to be made by experts that will have to apply them. Of particular importance is that domestic experts should become thoroughly acquainted with the CAP, in order to be able to cope with the challenges in the long years of negotiation and adjustment that await us.

Employment

In connection with employment or unemployment, Predrag Bejaković and Viktor Gotovac are concerned by Croatian labour policy and practice devoting more attention to the preservation of employment than to the creation of new job opportunities. For this reason it is necessary to encourage a more flexible labour legislation and remove the organisational and administrative barriers to the creation of new SMEs, which should help most in alleviating the problem of unemployment in Croatia.

The legal system

Siniša Rodin, in his paper on the legal system in Croatia, points out that certain constitutional changes are required in Croatia not only for EU membership, but even for the implementation of the SAA. In this process, the measure of harmonisation of the legal system will not be just the substance of the legal norms, but also the economic and social contents that are being governed by them.

The non-governmental sector

Igor Vidačak studies the relation between the non-governmental sector and the government, i.e., the civil dialogue. He claims that this relationship is behind EU standards, but not behind those of the candidate countries. Thanks to the high-quality work of the Office for NGOs, the first steps in the right direction have been made, but in order successfully to be able to meet the requirements of the SAA and for EU accession, the government still needs to take a number of measures as does, and more importantly, the non-governmental sector.

Equality between men and women

Snježana Vasiljević concludes that gender equality in Croatia has not been sufficiently regulated. Except at the constitutional level, so far no legal solution has been adopted to guarantee gender equality, or freedom of sexual orientation. Since this is one of the obligations of the country according to international law and the SAA, it is necessary to keep a constant eye on the development of this part of European law, to take over the approaches of the more advanced members of the EU, and as soon as possible to pass a special law or to build the most essential provisions into already existing laws and, of course, to sensitise the public.

CROATIAN CONVERGENCE WITH THE EU: THE CRUCIAL ISSUES

The authors of this book have adhered to a structure of work set in advance. Both because of this structure and because of the viewpoints and considerations of the authors, certain topics have run through all the papers here, such as the issue of legal regulation within the EU itself, the distinction between normative and the real conformity with the EU, the observation of Croatian advantages and failings, comparison with other countries, and in many of the recommendations the importance of the public administration and independent bodies is particularly highlighted, as is the question of whether adjustments need to be made at once or only when EU accession is impending, and a reference is made to our attitude to regional initiatives.

The issue of regulation within the EU

As already mentioned, the candidate countries have to take over and apply the acquis communautaire, the legal patrimony of the EU. The acquis is above all of a normative nature, but a large number of conditions that are set up have a political and economic nature. The topics worked on in this book sometimes are and sometimes are not covered by the acquis, and the authors themselves have defined the criteria that seemed to them to be crucial for joining the EU. When, for example, it is macroeconomics, banking, finances, trade and agriculture that are concerned, certain chapters of the acquis affect them directly, but in addition it is also necessary to respect the Copenhagen and Maastricht criteria as well as the conditions of the SAA.

In agriculture, the CAP needs to be borne particularly in mind, for it is one of the most important and complicated mechanismus of the EU from a legal, economic, regulatory and financial point of view. There is a specific situation with, for example, taxes, which do not have a special chapter in the acquis, but do have directives, very concrete in the case of indirect taxes, and much more generalised for direct taxes, the taxation of income being left entirely to the members.

Although there are directives for the area of taxation, because of the great unevenness of approach among the EU members relatively poor results in the harmonisation of taxation have been achieved. The situation with state aid is similar; there is a certain system of rules about how it is used, with possible bans and a concrete orientation about its reduction and its redirection from vertical to horizontal objectives. There is also no acquis about employment, there are no direct EU demands, and yet the authors point out that it is important to keep an eye on what is happening. Although the unemployment issue is within the sphere of competence of the member countries, there is a European Employment Strategy, a single framework that members apply diversely with different results.

No clearly defined acquis exists for the issues of the non-governmental sector either, nor for equality between men and women, and yet there are numerous strategic documents, rules, recommendations and international treaties, including the SAA itself, which are certainly binding on us.

All of this leads us to the conclusion that it is essential to educate experts of all profiles to keep up with the many requirements that

derive from the acquis itself, and for tracking the various regulations, directives, international treaties, the practice of courts and institutions, the practice of the member countries and practice in relations between the EU and the candidate countries. And here it is necessary to achieve complementarity in the knowledge of experts from various areas, and also the involvement of non-government experts in the process.

Normative and real conformity with the EU

Most of the authors in the book have stressed the need to distinguish the normative adoption of the conditions of the EU and putting them into practice. Rodin, for example, says that it is essential to create an appropriate environment, because conformity is not just the acceptance of norms, rather of functional and organic coalescence with them, the measure of conformity being not only the legal, but also the political, economic and social content of the adjustment. Concurring with this is Šonje, who is of the opinion that it is not enough to look only at the conformity of the legislation, for the real capacity of a country to meet the conditions depends on the structure and conduct of its institutions (in this case, of the banks, financial intermediaries and so on). Boromisa says the same thing, as do Franić and Žimbrek, who at the same time stress that it is easy to make laws, the main challenge, however, lying in the adjustment of the administrative structures that are going to implement them.

What is the situation in individual areas? In finance and banking, for example, with certain exceptions, we can on the whole be satisfied with both the regulations and their implementation in practice. In energy we have achieved a relatively high level of formal conformity, but implementation lags behind, that is, the legal system has been adjusted, but practice (interpretation and implementation) are developing in ways opposite to the principles of the EU. Requirements for equality between men and women and concerning sexual harassment, also, have not even been normatively met. Except at the constitutional level, no legal solution has been adopted to guarantee gender equality or freedom of sexual orientation, and there are no suitable laws to protect the rights of individuals at the normative level.

Croatia's advantages

Although we are all often more apt to point up the shortcomings, the bad side of the situation in Croatia, the authors in the book also draw attention to many Croatian advantages, that is, the good side. In terms of the economy, Mihaljek puts the stress on the favourable outlook for long-term growth and investment effectiveness, Šonje stresses the low rate of inflation, the harmonised interest rates, a stable rate of exchange, and a good banking system structure, while Arbutina, Kuliš and Pitarević note the advantages of the tax system, which is almost totally comparable with systems in the EU. Boromisa and Mikić, speaking of trade, state that Croatia started the convergence process at a higher level of development than some of the candidates, but also warn that these advantages could be lost after the first future enlargement of the EU.

Žimbrek and Franić note that in agriculture we can consider the relative richness of agricultural land an advantage, of course, with the many problems that need to be settled (the irrational management of it, the fragmentation of the land, the uncultivated and abandoned hectares and so on). As for measures for encouraging employment, Bejaković and Gotovac note that we are going in the right direction, albeit very slowly. Vidačak highlights the programme of cooperation between the government and the NGOs, which is a good take-off point for the development of a civil dialogue. The theoretical framework for this cooperation is excellently worked out, and it just needs to be applied in practice. Even in the area of gender equality there have been positive steps forward. Vasiljević notes that a provision concerning affirmative action was put into the 2001 Labour Law. A provision concerning sexual harassment was also proposed, but clearly this was too much for the legislator at one time.

Croatia, then, does have certain advantages. We have highlighted just a few of those stated in the book, and it is up to us to attempt first of all to recognise them, improve on them, and then make intelligent use of them.

Vulnerable points

The authors of the book have also diagnosed of course various points of vulnerability. In macroeconomic terms, Mihaljek points to the

low level of participation of the private sector in GDP, the high budgetary deficit, the large amount of the public debt, with a rapid growth in indebtedness, and the undeveloped securities market. Šonje repeats some of the fears (e.g., the fiscal deficit, the undeveloped securities market) but in particular puts forward the restrictive foreign currency regulations, that is, the closure to international financial flows. Arbutina, Kuliš and Pitarević are concerned by the tax burden, which is higher than in the EU, primarily because of high contributions. The Croatian economy is highly dependent on state aid, particularly sectoral aid (Kesner-Škreb and Mikić). Žimbrek and Franić stress the large deficit in the balance of trade and the lack of competitiveness of Croatian agriculture, as well as the serious social and economic aspect, for agricultural policy is actually being used as social policy. Bejaković and Gotovac too put forward the large expenditures for social policy and welfare and the inclination towards an exaggerated preservation of existing employment rather than new job creation.

In brief, the lack of competitiveness of the economy and the inadequate involvement of the private sector have led to the great involvement of the government, which entails a high budgetary deficit, a high public debt, a large tax burden, great outgoings for social security and so on. Economically looked at, we seem to be in a vicious circle in which revenue constantly has to chase after expenditure, and expenditure is constantly on the rise, pulling a growth in revenue in its tail. Below we shall make certain recommendations that might perhaps help us to emerge from this closed circle.

From the legal point of view, Rodin is concerned by the jurisprudential optimism and the uncritical flood of regulations that are not connected organically and functionally with real life. Nevertheless, it would seem that the special points of vulnerability, those points in which we fall furthest and most visibly behind, because of which we can fail the test most easily, are matters of the construction of civil society and protection of the rights of individuals. These are topics that are increasingly important in the EU, to which increasing attention is being devoted. For this reason it is a matter of concern that there is not even the most essential, at least normative, legal solution for some of these questions in Croatia, such as equality between men and women and the right to free sexual orientation.

A comparison of Croatia with the EU members and applicant countries

One of the objectives of the book was an attempt to compare the situation in Croatia with that in member countries and candidate countries. The most optimistic of our authors are Arbutina, Kuliš and Pitarević, who claim that the Croatian tax system is comparable with the system of the EU members and that, in the matter of taxation at least Croatia would easily join the EU. Mihaljek is also optimistic, stating that with respect to the Copenhagen criteria, Croatia is behind the member states, but not essentially behind the average for the CEE countries (being comparable, for instance, with Slovakia). Regarding the Maastricht criteria, Croatia has certain advantages to do with inflation, interest and exchange rates, and is worse off to do with the budgetary deficit. When looked at in the context of the SAA, however, it unfortunately is failing to meet the provisions about regional cooperation. According to Mihaljek, in the two areas where we are most behind, in the policy of market competition and the securities market, Croatia needs four years to catch up with the CEE average.

Kesner-Škreb and Mikić think that state aid in Croatia is not in harmony with the situation in EU members. Firstly, the amount of the aid given is considerably larger than in the EU and secondly it is mainly sectoral and not horizontal aid that is given. Also dissatisfied are Bejaković and Gotovac, for according to them the legal material dealing with unemployment is insufficiently harmonised with EU requirements, while the differences are still greater in practice. While in the EU the creation of new jobs is encouraged, Croatia looks more to the preservation of existing employment. And yet they do think that we are moving in the right direction, if only slowly.

There are also regions in which Croatia lags behind the members, but not essentially behind the candidate countries, or has similar problems. This can be said for the issues of gender equality and the development of the non-governmental sector, in which Croatia can even boast of a programme for cooperation between the government and the non-governmental sector of the kind that is a rarity even among EU members. The situation in trade and agriculture is particularly bad, here Croatia being slower and worse-off than both members and candidates.

Rodin is the most pessimistic, for he sees in Croatia a legal and cultural abyss created by decades-long separation from the European

and world mainstream. Of course, a break with traditional legal culture cannot be pulled off in a short period of time, but concentration on particular areas in which differences between Croatia on the one hand and member states and candidate states on the other is certainly possible.

Recommendations

The series of recommendations for an improvement of the economic situation is on the whole linked and consistent. Thus Mihaljek and Šonje highlight the need for rapid and stable growth, low inflation, external stability, fiscal adjustment, reduction of the deficit, reduction of the debt, stimulation of domestic savings, reforms of the labour market and the civil service. Subject to the success of these measures, Arbutina, Kuliš and Pitarević suggest the reduction of the tax burden (particularly of contributions) and Kesner-Škreb and Mikić propose reducing state aid, its redirection from vertical to horizontal targets and the foundation of an independent body for the supervision and implementation of aid. And anyway, Croatia is bound to do this because of the SAA. The case with energy is similar, an independent body already having been founded, although Boromisa stresses that it is necessary to draw up concrete plans of implementation with deadlines and clear divisions of authority and responsibility, and to harmonise theory and practice, for the regulations are good, and yet are interpreted and applied poorly.

Agriculture is a story all by itself; Žimbrek and Franić recommend measures to improve competitiveness while at the same time preserving domestic resources. Here it is exceptionally important to educate CAP experts who will be able to keep up in this complex material with experts from the EU as well as from competitive applicant countries. A certain disagreement can be seen among the authors in the book. Žimbrek and Franić advise liberalisation of trade through bilateral free trade agreements, especially with the Balkan countries, while Boromisa and Mikić are against such agreements, and in fact advocate even turning existing bilateral agreements into multilateral deals in order to reduce the administrative costs of implementation and monitoring.

From the point of view of law, Rodin states that it is necessary to make a break with traditional legal culture and to institute concrete changes to provide the legal basis for EU membership, including the governing of the manner of using state sovereignty. Here it is necessary to settle the status of international and European law in the Croatian

legal system. For the development of the non-governmental sector, Vidačak recommends intensive involvement in exchange programmes with EU members, which are quite possible before accession. The government ought to undertake numerous measures, but, which is still more important, the non-governmental sector should not look for everything from the government, but has to work on its own, develop cooperation within organisations, among organisations and with foreign associations, train experts, become more democratic and itself contribute to the development, adoption and dissemination of knowledge about the European integration process and insist that the government treats it as a partner. Vasiljević on the other hand says that for any progress from the impasse in the area of gender equality it is necessary to keep a constant eye on the development of European law, to adopt solutions from more advanced members, to make a dedicated law as soon as possible, or to put new provisions into existing laws, and to sensitise the public. Both Vidačak and Vasiljević stress the need for democratisation and constructive and non-monopolistic behaviour on the part of the NGOs.

Along with the many concrete proposals, most of the authors also stress the need to think about adjustment to a future and expanded, and not the current, EU, the importance of implementing the SAA, the importance of reforms of the administration, the foundation of independent bodies, and the education, education and education of all those involved in the integration processes.

The importance of the public administration and independent bodies

The question of the reform of the civil service runs through every chapter in the book and most of the authors (Mihaljek, Kesner-Škreb and Mikić, Boromisa, Žimbrek and Franić, Bejaković and Gotovac, Rodin, Vasiljević) think that in the process of adjustment and accession to the EU the main challenge is going to be the effectiveness of the administration. Boromisa, for example, describes an energy sector that is state owned, and will mostly remain so, state bodies thus being charged primarily with the implementation of energy reforms. This means that for a reform in energy, effective reform of the public administration is also necessary, or else a transfer of its authorities to an independent body.

Kesner-Škreb and Mikić also lay stress upon the importance of founding independent bodies to do with state aid, and Vasiljevic for cases of sexual discrimination and violations of the principle of equality between men and women. Bejaković and Gotovac urge reform of the public administration if there is a wish successfully to put through an active employment policy, while Rodin also urges this when talking of the break with traditional legal culture. Žimbrek and Franić also state that the main challenge to EU adjustment will be the adjustment of Croatian administrative structures and society. A key role will go here to domestic experts and the education of them, getting to know the CAP and mastering it in order to be able to carry out reforms and effectively negotiate with the EU. At all levels it will be necessary to invest in development divisions, research and education.

Adjustments at once or later

Most of, or in fact all, the authors in the book lay stress on the need for Croatian adjustments to EU requirements that are as rapid as possible. Rodin says that some changes are necessary right away, in the context of the implementation of the SAA, while some are essential for the outlook for full membership. However, in his opinion, Croatia will best express its genuine desire for full membership if it creates the premises for full membership now at the constitutional level. With this viewpoint, Mihaljek, Šonje, Kesner-Škreb and Mikić, Boromisa and Mikić, Žimbrek and Franić, Bejaković and Gotovac are in full agreement. Vasiljević adds that numerous treaties oblige us to act fast, and Vidačak points out that apart from adjustments to EU requirements, we should be vigorously involved right now in exchange programmes with members, this being possible before membership, because in this way we will be able to create the preconditions for the development of civil society and working for the general good.

Nevertheless, there are still some areas like the tax system where, Arbutina, Kuliš and Pitarević recommend, some of the adjustments need to be delayed right until the acquisition of the status of EU member. For although the situation in Croatia is currently not in line with EU requirements, it is nevertheless in the interests of Croatia, and adjustment would not anyway produce reciprocity. Thus each one of the areas needs separate and careful monitoring and studying, so that we shall know with certainty which adjustments need to be made as soon as possible, and which had better be deferred.

The attitude to regional initiatives

Most of the authors in the book have a positive attitude to regional initiatives. It is mainly stressed that the implementation of the SAA can help us in the process of restructuring, meeting the conditions for full membership, modernisation of the infrastructure, the use of financial resources for regional projects and adjustment of the laws so that in some areas Croatia could emerge as the leading nation in the region. Boromisa and Mikić stress that along with the necessary implementation of the SAA it is essential to do everything possible to become a member of the EU as soon as possible, thus minimalising the costs of partial liberalisation forced on us by the SAA. Žimbrek and Franić are actually able to point to the improvement in agriculture that has occurred since the signing of the SAA, especially in the harmonisation of legislation, the incentives to sustainable development, while Vasiljević recalls that the SAA also obliges us to respect the right of the individual.

Croatia is charged in the report of the European Commission with being insufficiently regionally cooperative, and so we do not have a lot of room for choice. In brief, one should not a priori cold-shoulder regional initiatives, rather try to make use of the advantages that they furnish, and use them intelligently for as rapid accession to the EU as possible.

CONCLUSION

In this book we have attempted to give a summary of some of the challenges of the economic and legal adjustment involved in Croatian accession to the EU. We have the while constantly borne in mind that negotiations with the EU are a politician's task, that our assignment is not to monitor the course of negotiations, rather to observe the state of affairs, to deal with given topics, even if they are currently not in line with government views, with EU demands or the actual course of negotiations. Politicians have tasks that they must do here and now, while independent experts can afford to observe and suggest, hoping to be useful in the long run. From this point of view, it is most important to be informed and expert, not only via keeping up with the literature, but also with events, in, for example, the world of business, in given branches of industry, in the media and so on.

We do not look at the EU as a set fact, rather as a construct, one that is constantly changing, and we consider adjustment to a future,

expanded, and not the present, Union. We point out that it is necessary to keep a constant eye on the development of conditions in the member countries and the applicant countries remaining after the next round of EU enlargement, because after they have joined we could well lose the advantages that we had. For this reason we have to concentrate on differences, on failures to keep up and adjust, and attempt to correct them.

In this text we have avoided speculations about any possible date of Croatian entry, a very unrewarding task, but do nevertheless mention the danger of a long period of lingering in the status of associated member with a very uncertain date of accession. This condemns us to many obligations without having a place at the table. Nevertheless, the criteria of Maastricht and Copenhagen, and most of the conditions of the SAA, can only be of use to us. It is our aim to meet as many as possible of these criteria, irrespective of whether we are or are not an EU member, or of some new creation that might exist when it is Croatia's turn.

Croatia has many *advantages*: a favourable outlook for long-term growth and efficient investment, a low rate of inflation, harmonised interest rates, a stable exchange rate, a good banking system structure, a tax system comparable with EU systems, rich agricultural land, even a good point of departure for civil dialogue. At the same time however it has a number of *drawbacks*: a low private sector involvement in GDP, a high budgetary deficit, a high public debt, an undeveloped securities market, closure to international financial flows, a high burden of taxation, dependence on state aid, large outgoings for social policy and welfare, an uncritical surge of regulations, and it often fails the test of constructing civil society and protecting the right of individuals. Our *objective* is to recognise and capitalise on the advantages, and also to identify and remove the shortcomings, and know how to make intelligent use of positive results, advances and improvements.

Although it would seem that political and legal conditions are crucial, in the long run, economic questions will also turn out to be decisive. For this reason our recommendations relate primarily to an improvement of the state of the economy, that is, for maintaining rapid and stable growth, low inflation, external stability, fiscal adjustment, deficit reduction, debt reduction, a rise in domestic savings, labour market reform, civil service reform, diminution of the tax burden, cutting state aid and greater influence from independent bodies.

Reforms have to be carried out before they are forced on us from outside, because if we do not start ourselves on time, perhaps the time will never come. Although adjustments have to be carried out as soon as

possible in most cases, nevertheless it is important to be careful, for there are areas in which it pays us better to wait until the moment of accession.

It is important to train experts for various areas capable of keeping up with EU specialists and those from current and future competitive applicant countries. It is necessary to keep our eye on the acquis as well as on the rules, regulations, directives, treaties, reports, decisions of courts and so on. Here it is important to distinguish the mere letter-of-the-law adoption of EU conditions and putting them into practice from putting them into the political, economic and social context. In all areas it is necessary to draw up concrete plans of implementation with deadlines and clear divisions of authority and responsibility. Whenever possible, it is worthwhile getting involved in exchange programmes with member states, and to make intelligent use of regional initiatives.

Although the government should undertake a great many measures, it is particularly important for the non-governmental sector not to expect everything from the government, but to work on its own, to cooperate, to get trained, to democratise itself, get rid of its monopoly, contribute to the development, adoption and dissemination of knowledge about integration and to make sure the government accepts it as a partner. We hope that this book will be a contribution to this and we shall go on working on the topics already started; in future projects we shall focus on additional topics such as the public administration, the courts, education, regional cooperation, political dialogue, human rights, democratisation and other topics that will arise in the course of time.

In short, our ideal ought to be to live in a country that meets the EU criteria, and if this is the case, being or not being a member will be of much less importance.

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[i] *The Economist, 26 October 2002, p. 27.*

[ii] *Surnames without sources indicated refer to chapters of this book.*

[iii] *Bartlett, W., 2002, The EU-Croatia Stabilisation and Association Agreement: A stepping Stone to Membership or Semi-Permanent Satellisation?, paper given at the conference Amadeus, European Enlargement to Eastern European Countries: Which Perspectives, University of Marne-la-Valle, 13-14 June 2002.*

[iv] *A lecture given by Vaclav Klaus on 24 April 2001 in the Faculty of Economics, Zagreb University.*

[v] *Joze Mencinger at the conference: "A New Dialogue between Central Europe and Japan, Part Five, The South-East European Countries in Transition, Between Globalisation, Integration and Fragmentation", held 12-14 September 2002 in Zagreb.*

[vi] *See the excellent Internet site of the MEI, www.mei.hr, and the very interesting, clear and popular publications such as What the Stabilisation and Association Agreement means for Croatia, 100 Questions about European Integration and the Pocket Lexicon of European Integration.*

Chapter 2

MACROECONOMIC ASPECTS OF CROATIA'S ACCESSION TO THE EUROPEAN UNION

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The one lesson that emerges is the need to keep trying. No miracles. No perfection. No millennium. No apocalypse. We must cultivate a sceptical faith, avoid dogma, listen and watch well, try to clarify and define ends, the better to choose means.
David S. Landes, The Wealth and Poverty of Nations (1999), p. 524.

ABSTRACT

This paper analyses the main macroeconomic conditions for joining the EU and the European Monetary Union (EMU), the readiness of the Croatian economy to meet these conditions, and the main challenges for economic policy on the road to these integrations. Croatia does not lag significantly behind the other CEE countries in fulfilling the criteria for EU and EMU membership. It has certain advantages with respect to the criteria of macroeconomic stability (with the exception of the budget deficit), investment efficiency, and potential growth. However, delays in the implementation of some structural reforms, in particular the development of a securities market,

**The views expressed here are those of the author and do not necessary represent those of the BIS. The author is taking part in this project as an independent researcher. He would like to thank an anonymous reviewer for helpful comments and suggestions.*

are estimated at about four years. The main challenges for economic policy in the run-up to EU and EMU are expected to be reducing the budget deficit and stabilising the public debt. Moreover, macroeconomic policies should remain prudent so as to strengthen external stability and maintain favourable conditions for growth.

Key words:
Croatian economy, Central European economies, enlargement of the EU, transition, convergence to the EMU, economic growth, inflation, external stability, budget deficit, public debt

INTRODUCTION

This paper analyses three topics related to Croatia's accession to the EU and EMU: the macroeconomic conditions for joining the EU and EMU, the preparedness of the Croatian economy to meet these conditions, and the main challenges that are awaiting economic policy on the road to the EU and EMU.

The second chapter describes certain differences in the process of EU integration as between Croatia and other CEE countries and analyses the economic significance of the criteria for EU membership, known as the Copenhagen criteria. These criteria relate primarily to the development of the fundamental political, economic, administrative and judicial institutions with the aim of creating as quickly as possible the conditions for the adjustment of the countries of CEE to the institutional framework of the EU. After they become EU members, the countries of Central and Eastern Europe will have the obligation to join the EMU and accept the euro as the common currency. To be admitted to EMU, countries will have to demonstrate that they are capable of maintaining macroeconomic stability for at least two years. To pass this test, countries will have to fulfil the Maastricht criteria on the rate of inflation, interest rate, exchange rate, budget deficit and public debt. Since these conditions are defined more precisely than the Copenhagen criteria and are easier to monitor, they are being thoroughly analysed in the literature, including this paper.

The third chapter assesses the readiness of the Croatian economy to join the EU and EMU. It carefully analyses comparative economic indicators for Croatia and five other Central European countries (Czech Republic, Hungary, Poland, Slovakia and Slovenia), as well as

some less developed current EU members (Greece, Ireland, Portugal and Spain). The main conclusion of these comparisons is that Croatia does not lag behind other Central European countries and even has certain advantages with respect to the main macroeconomic criteria (apart from the budget deficit), investment efficiency and potential growth. However, the delay in the implementation of some important microeconomic reforms, such as the development of non-bank financial markets and competition policy, is estimated at almost four years.

Chapter Four addresses the issues of the sustainability and stability of the process of real and nominal convergence. Although current indicators of macroeconomic stability for Croatia and other Central European countries are mostly satisfactory, the experience of some members of EMU shows that the final phase of convergence can be the most difficult. The main challenge for Croatia in this context will be to reduce the budget deficit and stabilise the share of public debt in GDP. Moreover, macroeconomic policies will have to remain prudent so as to maintain the external stability and make use of the potential for relatively strong growth. The fifth chapter concludes the discussion and provides some recommendations for economic policy.

CONDITIONS FOR JOINING THE EU

This chapter briefly considers the basic economic and institutional framework that the EU has elaborated for future members. The economically relevant criteria for the accession of Croatia to the EU can be divided into two groups: conditions that derive from the Stability and Association Agreement (2001), which the EU had expressly devised for the countries of SEE; and the Copenhagen criteria, which apply to all applicants from CEE and are also included in the Stability and Association Agreement. Criteria from the Maastricht Treaty on EMU have to be met by all EU members before they can adopt the euro as their common currency. The framework set in these three groups of criteria forms, in a way, a goal that the Croatian economy and, in particular, the public administration should aim for in the macroeconomic sphere in order to join the EU and EMU as soon as possible. In spite of frequent interpretations, most of these conditions have not been phrased extremely rigidly, but leave Croatia and other applicant countries a certain flexibility to adapt, in agreement with the European Commission, some of the conditions to the particular circumstances.

Box 1. The Stabilisation and Association Agreement

The SAA between Croatia and the EU was signed on 29 November 2001 and by summer 2002 it had been ratified by Austria, Denmark and Ireland. The Agreement governs cooperation and the framework for the gradual convergence of Croatia to European structures. The SAA contains provisions on cooperation and mutual obligations in the following areas: political dialogue, regional cooperation, free movement of goods, movement of workers, establishment of businesses, the supply of services, current payments and movements of capital, harmonisation and implementation of legislation and the rules of market competition, cooperation in the area of justice and internal affairs, the policy of cooperation and financial cooperation. Thus in the trade part of the Agreement a transitional period of three or six years in which Croatia will liberalise its market for industrial and agricultural products from the EU was agreed on. That is, as early as November 2000, the EU had decided, with certain exceptions, to liberalise its market for Croatian products.[ii] Apart from the provisions about political dialogue and regional cooperation, the provisions of the SAA closely resemble those of the Europe Agreements signed by the current accession countries.

In the regional cooperation provisions, it is anticipated that there will be a network of bilateral treaties with countries that have signed the SAA, other countries covered by the stabilisation and association process and with EU accession applicants. It is clearly stated that the goals of the regional provisions are the establishment of political dialogue, the establishment of an area of free trade in the region in line with WTO provisions, mutual concessions concerning the movement of workers, establishment, supply of services, current payments and movement of capital and other policies related to movement of persons, as well as cooperation in justice and home affairs. The creation of any kind of new state or other structures in the region is not envisaged in the Agreement, nor is it mentioned.

In the political preamble and in the appropriate parts of the Agreement it is clearly stated that Croatian accession to the EU will be based on the individual merits of Croatia. In particular, the readiness of Croatia to move from the status of potential candidate to that of official candidate for EU membership will be based on the individual capacity of Croatia to make the legal, economic and political adjustments required under the SAA and its readiness to contribute to regional cooperation and stability in SEE.

The Stabilisation and Association Agreement

Croatia's accession process differs from the accession of the current applicant countries – the Czech Republic, Hungary, Poland, Slovakia, Slovenia, the Baltic countries and Bulgaria and Romania. During the nineties, these countries initially obtained the status of associated countries after the EU entered into the so-called Europe Agreements with them. By carrying out these agreements, the associated countries, after a few years, acquired the status of candidates for membership in the Union.[i]

Because of the events of the war in the area of the former Yugoslavia, Croatia began developing closer relations with the Union only at the end of the nineties. In June 1999 the EU adopted the Process of Stabilisation and Association for the Republic of Croatia, BH, Albania, Macedonia and FR Yugoslavia) (European Commission, 2002a). The fundamental instrument for the implementation of the Process is the SAA. This treaty constitutes a new generation of agreements concerning associated membership in the EU. The main difference between the SAA and the Europe Agreements is in the contents of the so-called evolutionary clause, and in the provisions about regional cooperation (see Box 1).[iii] While the Europe Agreements specifically stated the integration of the countries of CEE into the EU as their basic goal, the SAA assigns Croatia the status of potential applicant for EU membership, on condition that it not only meets the Copenhagen criteria but also lives up to the obligations concerning regional cooperation. The rationale for these provisions is to encourage the countries in SEE to behave towards each other and work with each other in a manner comparable to the relationships that now exists between EU members (European Commission, 2002a). The requirement for the countries in the region to establish a network of close contractual relationships reflects the same logic on which the bilateral relationships with the EU (as represented by Stabilisation and Association Agreements) are built.[iv]

Joining the European Union

The basic conditions for the enlargement of the EU were already set out in Article O of the Treaty of Rome (1957), modified in 1997 in the Treaty of Amsterdam: "any European state which respects the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law may apply to become a Member of the Union

(European Commission, 2001,7). In 1993, at the Copenhagen European Council, the EU adopted a decision according to which the "associated countries in central and eastern Europe that so desire shall become members of the EU" (ibid. p. 8). The decision also defined the membership criteria – the so-called Copenhagen criteria – the basic objective of which was to set out the appropriate framework for the gradual integration of the countries of CEE into the EU:

- stability of institutions that guarantee democracy, the rule of law, human rights and the respect for and protection of minorities,
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union,
- the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

At the Madrid European Council in 1995, a fourth group of membership criteria was added:

- the adjustment of administrative and judicial structures to EU standards in order to ensure the effective implementation of the legislative framework taken over from the EU in the context of the first three items.

The legal patrimony of the EU that applicant countries bind themselves to take over and apply is known by the name of the acquis communautaire. The acquis is divided into 31 chapters:

1. Free movement of goods	18. Education and further education
2. Free movement of persons	19. Telecommunications and information technology
3. Free supply of services	
4. Free movement of capital	20. Culture abd audio-visual policy
5. Company Law	21. Regional policy and coordination of structural instruments
6. Market competition policy	
7. Agriculture	22. The environment
8. Fisheries	23. Consumer protection, health care
9. Transport policy	24. Cooperation in teh area of justice and internal affairs
10. Taxation	
11. Economic and monetary	25. Customs union
12. Statistics	26. Foreign relations
13. Social policy and employement	27. Common foreign and security policy
14. Energy	28. Financial control
15. Industrial policy	29. Financial and budgetary provisions
16. Small and medim sized enterprises	30. Institutions
17. Science and research	31. Miscalleneous

Probably the most important macroeconomic criteria for joining the EU are central bank independence and the prohibition on central banks financing of national budget deficits. The European Central Bank assesses regularly the fulfilment of these conditions. During 2002, the ECB several times gave public warnings to the governments of the Czech Republic, Hungary and Poland that some of the proposed laws were encroaching on the independence of the central banks and hence jeopardised the chances of these countries to successfully conclude their accession negotiations.

The actual accession negotiations deal primarily with conditions under which the applicant countries will accept, apply and administratively and legally implement different chapters of the acquis. Experience to date has shown that there is enough flexibility in these negotiations for individual legislative approaches to be adapted to the specific conditions. Poland, for example, negotiated a transitional period of 12 years for the complete liberalisation of the market in agricultural land (including the right of Union residents to buy agricultural land in Poland), while the European Commission, during the negotiations, had proposed a period of seven years. In other words, how much, during the assumption of the acquis, given solutions will suit the interests of the applicant country depends, among other things, on the expertise and capacities of the relevant structures of the public administration in its negotiations with the EU.

Candidate countries are obliged to accept national programmes for implementation of the acquis, and the EU regularly assesses the progress made in the implementation of these programmes. By summer 2002, all the applicant countries from CEE had started negotiations on about 30 chapters of the acquis (apart from Romania, currently negotiating about 24 chapters). Most chapters have been agreed on with Lithuania (28), then with Estonia, Latvia and Slovenia (27 chapters each), Slovakia (26), Czech Republic and Poland (25), Hungary (24), Bulgaria (20) and Romania (12) (Deutsche Bank, 2002). Croatia is bound to meet the Copenhagen criteria pursuant to the SAA; the results achieved in this area will be considered in the next chapter.

Since considerable financial resources are necessary for accepting the acquis and meeting the other conditions for membership, the European Council earmarked up to 3.12 billion euros in its financial plan for 2000-2006 for assistance to applicant countries (European Commission, 2001). From 1993 to 2000, Croatia received a total of 358 million euros in assistance from the EU, and the value of the CARDS programme for 2001 amounted to 60 million euros (European Commission, 2002b).[v]

Joining the European Monetary Union

The eleventh Copenhagen criterion provides for the implementation of the objectives of economic and monetary union in the medium term. Unlike the current members of the EU who have not joined the EMU – Denmark, Sweden and the UK – the countries of CEE will not be able to opt out of membership in EMU when they have met the conditions for joining laid down in the Maastricht Treaty of 1992. These conditions are as follows:

- *Inflation*. A Member State has to show a price stability performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions
- *Interest rate.* Over a period of one year before the examination, a Member State has to have an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions;
- *Exchange rate*. A Member State has to respect the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency on its own initiative for the same period.
- *The general government deficit* may not exceed 3% of GDP, or should be falling substantially or only be temporarily above though still close to this level;
- *Gross general government debt* may not exceed 60% of GDP at market prices, or must at least show a sufficiently diminishing (rate) and approaching the reference value at a satisfactory (rate).

Since these conditions are more precisely defined than the other Copenhagen criteria, they have become in economic and business literature a synonym for the readiness of applicant countries to join the EU. For this reason, this paper will also devote considerable attention

to the comparison of Croatia's macroeconomic performance with the Maastricht criteria. It is necessary, however, to stress that these conditions need to be met only after the future members of the EU have spent at least two years in the Exchange Rate Mechanism (ERM II) of the European Monetary System.

Although at first glance these conditions seem to have been laid down very precisely, there is a certain amount of flexibility in them. This pertains in particular to the size of public debt, or the tendency of the debt to decline. Austria, Belgium, Greece, Italy and Holland entered the EMU with a public debt in excess of 60% of GDP, and by the end of 2001 only the Netherlands had reduced gross indebtedness below that level.[vi] Italy also had problems meeting the budget deficit criterion. From 1991 to 1996 the average budget deficit amounted to 9% of GDP. As a criterion for EMU entry, the European Commission accepted the promise (later fulfilled) that the deficit for 1997 and 1998 would be lower than 3%. However, as far as Croatia is concerned, it would be wiser not to rely on such precedents and meet all the criteria from the outset, for the probability that the European Commission in an enlarged EU would-be particularly well-disposed towards Croatia is very small.

THE READINESS OF THE CROATIAN ECONOMY FOR THE EU

After the main economic criteria for Croatia's accession to the EU have been laid out, i.e., the objectives that the Croatian economy should aim for in order to join the EU, this chapter considers the initial conditions on the road to EU, i.e., to what extent the Croatian economy lags behind or has any initial advantages over the EU applicant countries. The analysis is divided into four parts: (i) a review of the basic economic indicators of Croatia, the CEE countries, and the less developed current members (Ireland, Greece, Portugal, Spain); (ii) the evaluation of the EU concerning SAA implementation; (iii) a review of EBRD transition indicators, which, to a certain extent, quantify the Copenhagen criteria on the functioning of the market and the competitive strength of the economy; (iv) an evaluation of the macroeconomic performance of the Croatian economy based on the Maastricht criteria. The general conclusion is that Croatia does not lag behind the other CEE countries, or even has certain advantages in terms of the main macroeconomic indicators. However, there is a marked delay in the

implementation of some important microeconomic segments of the acquis, such as the legal system, competition policy, the development of the non-bank financial system and the share of the private sector in the economy. Since these institutions are vital for the normal functioning of the market economy and competitiveness of the corporate sector, it can be estimated that, provided macroeconomic stability is preserved, Croatia will need another four to five years of structural reforms to catch up with the level of readiness for EU already achieved by the advanced transition economies.

The main economic indicators

With GDP per capita of $4,600 in 2001 (24% of the EU average), Croatia was in the same position as Hungary and Poland (Table 1). The per capita income of the Czech Republic was 30% higher, and that of Slovenia 130% higher, while compared with Slovakia per capita income in Croatia was a quarter higher. Greece, Ireland and Spain had a considerably higher *per capita* income (in terms of EU average) before joining the EU.[vii] However, Portugal had in 1986 the same per capita income in terms of EU average as Croatia in 2001. Judging by this basic indicator of development, then, Croatia does not lag substantially behind the other applicants for EU membership.

Also surprising is the fact that Croatia does not lag behind in terms of two other basic indicators: GDP growth and labour productivity growth. From 1995 to 2001, real GDP in Croatia rose at an average annual rate of 4%, somewhat slower than in Slovenia, but 10% faster than in Hungary and twice as fast as in the Czech Republic.[viii] Only the Slovak and Polish economies grew faster on average over this period. With a productivity growth of 5.4% in the 1995-2001 period, Croatia was in the first place among the countries considered; productivity growth of more than 4% per annum was achieved only in Poland and Ireland. Wages rose twice as fast as productivity, however (by 11.4% a year in real terms), so the competitiveness of the Croatian economy was considerably reduced according to this criterion. Rapid growth in productivity was partly achieved through reduction in employment, on average by 1.3% a year, highest among the countries in central Europe.[ix] Together with Poland and Slovakia, Croatia also stands out in terms of very high unemployment; the other central European countries have reduced their rate of unemployment to below 10% and thus have converged with the EU average.[x]

Table 1. Main economic indicators for the Central European contries and the EU

	Population 2001 (mil.)	GDP 2001 (billion EUR)	Per capita GDP		Growth rate 1995-2001[1]			Unemployment rate[4,5]
			USD[2,3]	Percentage of EU average[3]	Real GDP	Productivity	Employment[4]	
Croatia	4.4	22.6	4,605	24	4.0	5.4	-1.3	16.3
Czech R.	10.3	62.1	5,530	29	2.0	2.5	-0.5	8.9
Hungary	10.0	57.4	4,660	24	3.6	3.3	0.4	8.4
Poland	38.7	197.8	4,560	24	4.8	4.5	0.4	17.3
Slovakia	5.4	22.7	3,700	19	4.4	3.8	0.6	18.2
Slovenia	2.0	20.9	10,605	56	4.1	3.1	1.0	5.9
EU members								
Greece	10.9	30.4	5,700	63	3.3	2.5	0.8	10.4
Ireland	3.9	96.7	2,420	57	9.2	4.0	5.1	3.8
Portugal	10.3	122.6	2,240	24	3.3	0.8	2.7	10.6
Spain	41.1	651.6	4,420	47	3.5	3.1	0.3	4.1
EU	377.5	8,812	19,060	100	2.6	1.5	1.1	8.0

[1] Annual average, in percent.
[2] GDP at current prices in domestic currency, converted into US dollars at annual average exchange rates.
[3] For current EU members, GDP per capita and percentage of EU average in year of joining the EU (Greece 1981, Ireland 1973, Portugal and Spain 1986); For EU candidate countries data refers to 2001.
[4] Based on labour force surveys.
[5] Average for 2001.

Sources: UN Economic Commission for Europe; European Central Bank; IMF; Eurostat; EBRD; national statistical agencies

By far the best economic performance among the countries in Table 1 was achieved by Ireland. With a growth of as much as 9.2% pa, the real GDP of Ireland increased by 70% between 1995 and 2001, and per capita income by 44% (from 18,500 to 26,600 USD). Moreover, Ireland achieved a growth rate of employment of more than 5% a year, resulting in a decline in unemployment from about 15% at the beginning of the nineties to only 3.8% in 2001. Ireland can therefore justly stand as a model for the transition economies.

Evaluation of the European Commission from April 2002

In its first stabilisation and association report on Croatia from April 2002, the European Commission evaluated that Croatia had continued to make progress in the process of transition to a free market economy (European Commission, 2002c). Concerning regional cooperation – the main additional condition for Croatia's accession to the EU – the European Commission judged that the government accepted the need to normalise relations and strengthen bilateral cooperation with neighbouring countries. However, Croatia continued to fear that closer relations with the neighbours would lead to the re-emergence of a regional identity and hold back its ambitions for European integration. As a consequence, "the authorities show a clear lack of enthusiasm for any regional initiatives with the other SAA countries" (ibid., p. 10). This evaluation does not diminish the considerable success achieved in concluding bilateral free trade agreements with BH, Macedonia, Hungary, Slovenia, Bulgaria, Czech Republic, Poland, Romania, Slovakia and Turkey, and the negotiations on free trade that started at the time with Albania and FR Yugoslavia (and have since been successfully concluded).

Regarding fulfilment of the Copenhagen criteria, the following judgements of the European Commission should be noted.

As for the political conditions, the European Commission is concerned by the situation in the judiciary, which are characterised by serious organisational problems, inefficiency of procedures, lack of expertise and long delays in the conclusion of cases. "Radical reforms are needed but no substantial progress has been made. This weakness has direct impacts on implementation of the rule of law, which remains problematic and uneven" (ibid., p. 4).

Turning to the existence of a free-market economy and structural reforms, the European Commission notes that a major part of the economy is privately owned; privatisation and restructuring of state-owned firms is proceeding slowly; and the importance of the grey economy is estimated to have declined (ibid., pp. 15, 17). However, the ability of the corporate sector to withstand competitive pressure and to cope with market forces in the Union differs considerably across sectors.

- Agricultural products (10% of Croatia's total imports, of which 42% comes from the EU, and 14% of total exports, of which 10% goes to

the EU) are considered uncompetitive on the EU market. Since the degree of protection of agriculture was very high in the past, it is estimated that agriculture will be most sensitive to trade liberalisation (ibid., pp. 20 and 25).

- Regarding industrial products, the Commission notes that implementation of the Interim Agreement (through which trade with the EU was liberalised in 2000) has not raised problems so far. Since Croatia is the largest exporter to the EU from south-eastern Europe, it is expected to be by far the most significant beneficiary of EU trade liberalisation. However, the Croatian balance of trade with the EU remains highly negative "due to the substantial reduction in Croatia's overall export level following its loss of international competitiveness – due essentially to wage growth above productivity growth, delayed enterprise restructuring and insider privatisation. This trend now seems to be slowly improving however." (ibid., p. 20).
- The SME sector, which accounts for almost 45% of GDP, is slowly becoming more dynamic, in particular by comparison with big industry. But the international competitiveness of small and medium sized enterprises is still low, and their orientation to foreign markets is small (ibid., p. 24).
- The service sector has been opening fast and performs well, with growth of service exports above 10% pa. Croatia accounts for 70% of the region's exports of services. (ibid., p. 22).
- In transport infrastructure, the European Commission sees Croatia as an important transit country for road, rail and combined transport in the Union. In the development of the energy sector, Croatia has a potentially crucial role in the region. However, the Commission is disappointed with the financial performance of HEP (electricity) and INA (oil and gas), the state-owned companies that currently dominate their sectors and enjoy a quasi-monopolistic position. This can be partly attributed to insufficient investment in the energy infrastructure. The Commission is also concerned by the fall in the production of domestic oil and gas and the faster rise in the consumption than in the production of electricity (ibid. pp., 26-17). By contrast, Croatia leads in the region in the telecom sector owing to successful privatisation, large investments and adequate regulation (ibid., p. 27).

In the financial system, the Commission notes that the results of privatisation and the consolidation of the banking system have been favourable and have strengthened the confidence of depositors in the banks. The new central bank law, which provides for greater independ-

ence of the CNB and mandates the central bank to put a strong emphasis on price stability as the basic objective of monetary policy, is also viewed positively. However, long-term finance is still scarce (because of problems with collateral); the non-banking financial system is poorly developed; and the environment in Croatia remains difficult for domestic and foreign investment due to deficiencies in the bankruptcy law and proceedings, inaccurate and incomplete cadastral records and land registry, and significant and numerous bureaucratic hurdles) (ibid., pp. 16-17).

In connection with public finances it is pointed out that the tax burden on the private sector in Croatia is among the highest in the region, which has lowered profitability and driven some activities off into the grey economy. The introduction of a single treasury account has improved the management of the budget. However, the national budget is not comprehensive and there are weaknesses in the formulation, execution and control of budgetary resources (ibid., p. 17).

With respect to the adjustment of administrative structures to EU standards, the Action Plan for the Implementation of the SAA is viewed as evidence of the seriousness of the commitment of the government. However, the timetable, which would require the government to transfer 70% of the acquis in two years, is judged as highly ambitious and, in the light of the experience of other countries, potentially unrealistic. In particular, there is a lack of capacity, in terms of staff numbers and the proper expertise necessary for the adjustment of many sectors to European standards and the gradual implementation of the acquis (ibid. p. 19). Encouraging initial results in the harmonisation of legislation have been achieved in several areas: movement of capital, protection of intellectual property rights, the company law (especially equal treatment of foreign and local investors), accountancy standards etc. In many areas, e.g., in consumer protection, industrial standards, the implementation of the legislation on market competition, the regulation of state aid to industry, considerable progress has yet to be made.

The functioning of the market and the competitiveness of the economy

Is it possible to test independently the evaluations of the European Commission on the functioning of market economy in Croatia? To assess whether some market economy functions normally and whether the corporate sector can withstand the competitive pressure

Table 2. EBRD transition indicators, 2000[1]

	Croatia	Czech R.	Hungary	Poland	Slovakia	Slovenia	Croatia/ SE-5[2]
Market	3.2	3.4	3.5	3.5	3.4	3.4	92
Price liberalisation	3.0	3.0	3.3	3.3	3.0	3.3	94
Trade and foreign exchange system	4.3	4.3	4.3	4.3	4.3	4.3	100
Competition policy	2.3	3.0	3.0	3.0	3.0	2.7	78
Enterprises	3.3	3.9	3.9	3.5	3.4	3.4	92
Small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	100
Large-scale privatisation	3.0	4.0	4.0	3.3	3.0	3.3	85
Enterprise reform	2.7	3.3	3.3	3.0	3.0	2.7	88
Financial institutions	2.8	3.2	3.9	3.5	2.7	3.0	87
Banking system	3.3	3.3	4.0	3.3	3.0	3.3	98
Non-bank financial	2.3	3.0	3.7	3.7	2.3	2.7	75
Infrastructure	2.6	2.8	3.8	3.7	2.6	2.9	85
Legal system	3.0	3.4	3.9	3.9	3.0	3.9	82
Commercial law	3.0	3.4	3.9	3.9	3.0	3.9	84
Financial regulations	3.0	3.5	4.0	4.0	3.0	4.0	81
Aggregate indicator[3]	**3.1**	**3.5**	**3.8**	**3.6**	**3.1**	**3.4**	**90**
Memo item:							
Private sector share of GDP[4]	60	80	80	75	80	65	79

[1] *Meaning of indicators is explained in text.*
[2] *Indicator for Croatia divided by the average indicator for five other CE countries (CE-5), in percentages.*
[3] *Unweighted average of individual average.*
[4] *In percent of GDP; EBRD estimate for mid-2001.*

Source: EBRD (2001, 2002) and author's calculations

inside the EU one would need to consider many different macro- and microeconomic indicators. But even after such detailed analysis, any final assessment of the preparedness of an economy for the EU would reflect to a certain extent subjective judgement. In other words, there is no summary indicator or a completely satisfying set of multidimensional indicators of the degree of "maturity" of a market economy. There are, however, certain approximations that can help make an informed judgement with a fair degree of confidence. Since 1994, the EBRD has been preparing it's the so-called transition indicators that rank the transition economies on a scale from 1 (the infancy of a market economy) to 4 (developed market economy) according to five groups of criteria – market, enterprises, financial institutions, infrastructure and legal system. The indicators for Croatia and for five Central European economies are shown in Table 2. The last column shows the value of the indicator for Croatia as compared with the average of the other five countries; a value lower than 100 indicates a gap between Croatia and the average of the five accession countries; a value of 100 means that Croatia has an equal starting position; a value greater than 100 indicates an advantage vis-à-vis the other countries.

According to the aggregate transition indicator, Croatia lags about 10% behind the average of the selected transition economies, and is comparable with Slovakia. The greatest progress has been made in trade and foreign exchange system and in small-scale privatisation. However, in several areas there is a pronounced difference between Croatia and other accession countries:

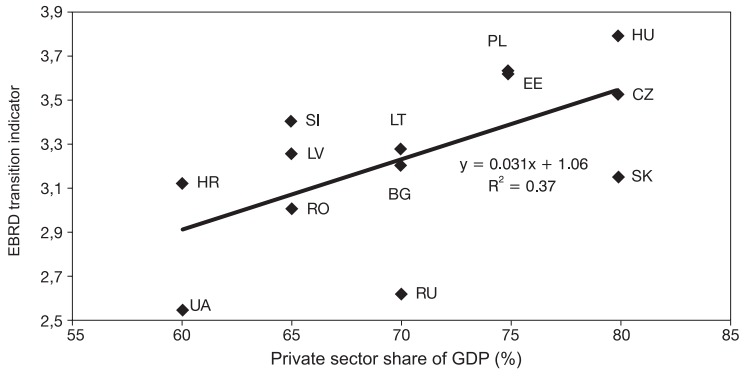
- In competition policy Croatia has scored the lowest value of any indicator in the table (2.3) and lags more than 20% behind the more advanced transition economies. The low value of this indicator reflects high obstacles to the entry of new firms to the market, and inadequate implementation of the legislation and policy of market competition with respect to firms that have a dominant market position.
- In the category of the non-bank financial institutions, Croatia lags as much as 25% behind the average of the applicant countries. The low value of this indicator reflects the existence of a shallow securities market and the low level of activity of brokers and other non-bank financial intermediaries, as well as the rudimentary legislative framework for the issuance of and trade in shares and bonds.
- In terms of development of the legal system Croatia lags about 20% behind the average. The basic reasons are the inadequate and incon-

sistent application of the financial system laws and regulations, in particular inadequate protection of the interests of creditors and owners and problems with bankruptcy laws and procedures, because of which legal uncertainty prevails. By contrast, commercial legislation is judged to be adequate and the corresponding indicator is slightly above the average for other countries.

- Because of poor corporate governance, inconsistent implementation of the laws relating to bankruptcy and the lack of commitment in strengthening market competition, Croatia still faces significant problems with large-scale privatisation and enterprise reform.
- There is also a considerable delay in the introduction of market principles in the infrastructure, which covers energy, road and rail transportation, telecommunications and water supply.

Low values of transition indicators are statistically highly correlated with the private sector share of GDP. Croatia had in 2000 the lowest private sector share in GDP of all the central European countries, only 60%, the same as Macedonia, Ukraine and some Central Asian economies. The coefficient of correlation between the aggregate transition indicator and the private sector share of GDP is 0.6. A simple regression shows that for each 10 percentage point increase of the private sector share in GDP, the aggregate transition indicator rises by 0.3, i.e., by a tenth of the average value of this indicator in 2000 (Figure 1).[xi]

Figure 1. Transition indicator and private sector share of GDP



Source: EBRD, 2002; author's calculations

How long would it take Croatia to make up the large delay in competition policy and non-bank financial institutions vis-à-vis the other central European countries? To answer this question, we calculated the time that it took the Czech Republic, Hungary, Poland and Slovenia to increase the average value of this indicator from 2 to 3. In competition policy, it took these countries 3.5 years on average for this increase, and in non-bank financial institutions 3.8 years.

It should be noted that the transition indicators in Table 2 refer to the situation as of 2000. Since then, there has been progress in some reform areas in Croatia, but also in the other CE economies, so the relative position of Croatia has probably not improved significantly

Convergence to the EMU

To what extent do Croatia and the CE transition economies already meet the macroeconomic conditions for joining the EMU? To answer this question it is necessary to recall that the decision on the initial members of the EMU was made in 1998 based on the data for 1997, and that enlargement of the EU to Cyprus, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia is expected in 2004. Some of these countries could qualify to join the EMU as early as 2007. Hence, an assessment of the readiness of the transition economies for the EMU based on the data for 2001-2002 is equivalent to the assessment of the preparedness of Ireland, Spain and Portugal for EMU based on the data for 1993 (for Greece, based on the 1995 data). At that time, the Maastricht criteria had not been elaborated, so data for Germany served as the reference value (Table 3).

The transition economies were clearly much closer to meeting the nominal convergence criteria in 2000–2001 than the less wealthy current members of the EU were in the first half of the nineties. This relates above all to public debt, which in all the transition economies is below 60% of GDP (though Croatia and Hungary are approaching the critical level), while in Greece, Ireland, Portugal and Spain the public debt amounted to 61-109% of GDP. Croatia, the Czech Republic and Poland also meet the conditions for inflation, and Croatia, the Czech Republic and Slovenia the condition for the long-term interest rate on government bonds. All the six CE countries meet the condition for exchange rate stability. The largest deviation from the Maastricht pertains to the budget deficit. In 2001, only Slovenia had a deficit below the critical level of 3%

Table 3. Criteria for convergence to EMU

	Price stability[1]		Long term interest[2]		Exchange rate stability[2,3]		Budget deficit[4]		Public debt[5]	
	1999	2002	1999	2002	1999	2001	1999	2001	1999	2001
Croatia	4.3	2.5	12.7	5.7	-4.4	2.4	-8.2	-6.6	49	52
Czech R.	2.1	2.7	5.6	4.6	1.0	8.2	-3.1	-5.5	29	29
Hungary	10.0	5.7	13.4	7.5	-3.3	4.7	-3.7	-4.1	61	53
Poland	7.3	2.8	16.2	7.5	-2.5	8.3	-3.4	-5.3	45	45
Slovakia	10.7	3.6	15.0	7.3	-1.4	0.4	-3.4	-3.9	28	34
Slovenia	6.1	7.5	4.9	5.6	-3.9	-4.9	-0.6	-1.4	25	23
Average	*6.8*	*4.1*	*11.3*	*6.4*	*-2.4*	*3.2*	*-3.7*	*-4.5*	*40*	*39*
Reference value[6]	**0.6+1.5**	**1.3+1.5**	**4.6+2**	**4.6+2**	**± 15**	**±15**	**-3.0**	**-3.0**	**60**	**60**
Greece (1995)	8.9		23.1		0.4[7]		-9.3		109	
Ireland(1993)	1.4		9.9		-8.2[7]		-2.5		96	
Portugal (1993)	6.7		16.5		-4.5[7]		-6.8		61	
Spain (1993)	4.6		12.8		-9.0[7]		-6.7		64	
Average for 4 EU members	*5.4*		*15.6*		*-5.3*		*-6.3*		*82*	
Reference value: Germany (1993)	4.4		12.9		...		-2.4		47	

[1] Annual average, in percent. Data for 2002 refer to the first half of the year.
[2] On ten-year government bonds, end of period; data for 2002 refer to mid-2002.
[3] Deviation of end-period exchange rate vis-à-vis the euro from average exchange rates for 1998-99 and 2000-02, respectively.
[4] General government deficit (accrual basis), in percent of GDP.
[5] Domestic and external public sector debt (general government basis), in percent of GDP.
[6] Inflation and interest rate data for three euro countries with lowest inflation (in first half of 2002, Germany and Finland (1.3%), and Austria and Belgium (1.4%); other criteria based on the Maastricht Treaty.
[7] Change in annual average exchange rate vis-à-vis the deutsche mark, 1992-93 (for Greece, 1994-94).

Source: Economic Commission for Europe; European Commission; IMF; central banks; national statistical agencies

of GDP. Croatia had a deficit of as much as 6.6% of GDP, highest in central Europe in 2001.[xii] However, transition economies were again much closer to meeting this criterion than Greece, Ireland, Portugal and Spain five years before they joined the EMU. One should also point out that the transition economies have to meet much more stringent inflation and interest rate criteria than Ireland, Portugal and Spain in the mid-nineties. At the time, inflation and interest rates in the reference country, Germany, were considerably higher because of the macroeconomic pressures following German reunification.

Compared with the other CE countries, Croatia is in a sound position with respect to three criteria: inflation (it had the lowest rate of inflation in the first half of 2002, only 2.5%), long-term interest rates, and exchange rate stability. However, together with the Czech Republic and Poland, Croatia needs to undertake considerable fiscal adjustment: the budget deficit needs to be cut by more than 3.5% of GDP. Another cause for concern is the high level of public debt (52% of GDP), particularly if one takes into account the rapid increase in debt in the second half of the nineties. Hence, although Croatia meets the macroeconomic criteria for joining the EMU at the moment (with the exception of the budget deficit), the issue is whether the current macroeconomic performance is sustainable over the medium term. This question is addressed in the next chapter.

IDENTIFICATION OF MACROECONOMIC VULNERABILITIES

The experience of some current members of EMU indicates that hopes about a steady fulfilment of the convergence criteria can unexpectedly and suddenly go sour. At the beginning of the nineties, when it seemed that the convergence process was almost complete, the EMS did not survive the burden of speculative attacks. The grounds for the speculation were doubts that arose in financial markets that some members of the EMS would be able to mobilise adequate political support for the implementation of the remaining fiscal adjustment. There were also concerns that exchange rates of some currencies within the EMS were overvalued. The experience of Spain is particularly instructive. At the beginning of the nineties Spain was growing very rapidly, it enjoyed the confidence of international capital markets and attracted large inflows of foreign capital. Convergence seemed within striking distance. However,

wages began to rise rapidly in an environment of expansion, leading to higher inflation and undermining competitiveness of the economy, so that in 1992 Spain was forced to devalue the peseta.

Since Croatia and the other CE countries also face high current account and fiscal deficits, and inflows of capital are creating a more or less constant pressure on exchange rates and monetary policy, the question arises as to whether they too will face a similar fate, irrespective of the high degree of macroeconomic stability already achieved. To answer this question, it is necessary to establish the actual degree of macroeconomic stability and the main points of vulnerability at the macroeconomic level. This paper deals with four questions: the outlook for rapid and sustainable long-term growth, the outlook for low inflation; external vulnerability, and the dynamics of budget deficits and public debt.

Outlook for long-term growth

What are the perspectives for long-term growth in Croatia and the other countries of CE? Apart from the Czech Republic, real GDP in CE economies has expanded on average by 4-5% pa since 1995 (Table 4). Domestic demand – final consumption and gross investment – has in all the countries (with the exception of Hungary) made a greater contribution to GDP growth (1.2 percentage points a year) than net exports. In other words, only in Hungary have net exports been sufficiently large to contribute to the growth of GDP. By contrast, negative contribution of net exports has reduced the growth of GDP in Croatia and Slovakia by an average of 1.5 percentage points a year. This implies that domestic demand has grown too fast, and exports too slow, for the current composition of sources of growth in Croatia and Slovakia to be sustainable over the long term.

This conclusion is supported by an analysis of the sources of saving and investment. During 1995-2001, Croatia achieved an average investment rate of 24% of GDP. Since the rate of domestic saving was less than 18% of GDP, it was necessary to "import" more than 6% of GDP of foreign capital per year in order to close the gap between domestic investment and saving.[xiii] In this period, only Slovakia relied more heavily on foreign borrowing. By contrast, Slovenia financed more than 95% of its investment from domestic saving (Croatia, only 74%).

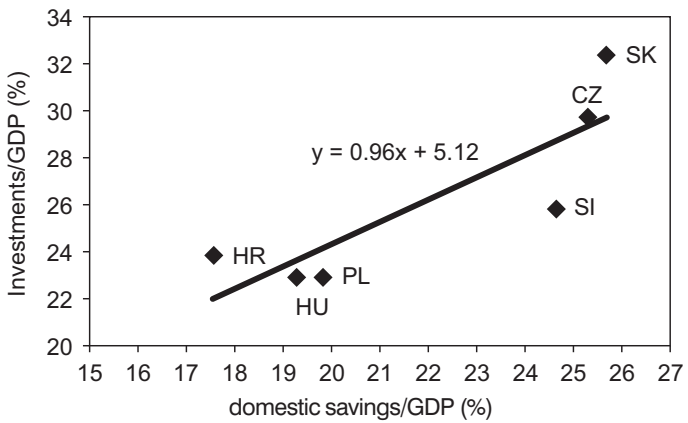
Table 4. Long-term growth, investment and saving in CE, 1995-2001

	Growth of real GDP[1]	Contribution of domestic demand to GDP growth[2]	Contribution of net exports to GDP growth[3]	Potential growth rate[4]	Investment rate	Domestic saving rate	Current account balance
Croatia	4.0	5.5	-1.6	5.0	23.8	17.4	-6.3
Czech R.	2.0	3.2	-1.2	3.5	29.8	25.3	-4.5
Hungary	3.6	2.7	0.9	4.7	22.9	19.2	-3.6
Poland	4.8	5.6	-0.8	4.8	22.9	19.8	-3.1
Slovakia	4.4	5.9	-1.5	5.2	32.5	25.7	-6.8
Slovenia	4.1	5.1	-0.9	5.6	25.9	24.6	-1.2
Average	*3.8*	*4.7*	*-0.9*	*4.8*	*26.3*	*22.0*	*-4.3*

[1] Average annual growth rate, in percent.
[2] Annual average; in percentage points.
[3] Data for Croatia based on Mihaljek (2000); for Slovakia, on Consensus Economics (2002); for other countries, on Huizinga et al. (2002).
[4] Percent of GDP-a, annual average.

Sources: UN Economic Commission for Europe; European Central Bank; IMF; national statistical agencies

Figure 2. Investment and domestic savings, 1995-2001



Source: Domestic statistical agencies; ECB; author's calculations

High current account deficits are not necessarily harmful to economic growth, provided that investment goods rather than consumer items are imported. In the structure of Croatian imports from

1994 to 2000 a relatively high 20% is accounted for by investment goods, and a moderate 29% by consumer goods, while raw materials and intermediate products accounted for 51% of total imports. This is a relatively high amount even if corrected for imports of energy (about 15% of total imports).[xiv] In other words, the main challenge for the long-term sustainability of the current account in Croatia is not excessive personal consumption, but rather insufficient domestic production of various intermediate products for industry and services. The main producers of such goods are usually small and medium-sized firms, often in cooperation with foreign partners.

It follows that the dynamic development of this sector and the acceptance of the principle of specialisation and globalisation in production are necessary to achieve long-term sustainable growth.

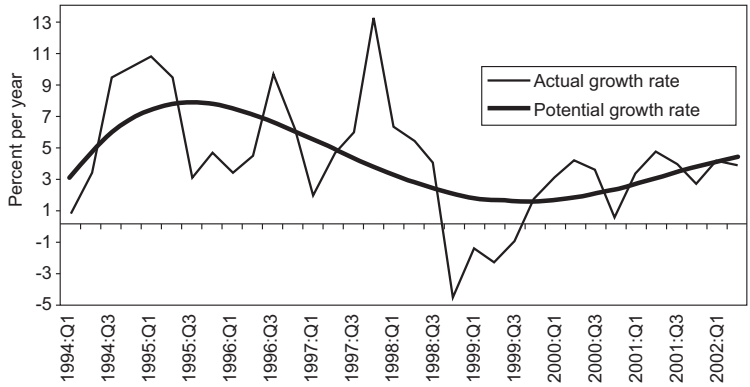
Croatia, on the other hand, stands out in terms of high efficiency of investment. With a rate of investment that is 6% of GDP lower compared to the Czech Republic and 9% lower compared to Slovakia, Croatia had achieved a growth rate of GDP that is twice as high as in the Czech Republic and almost the same as in Slovakia. Together with Poland and Hungary, Croatia has achieved a similar efficiency of investment as the USA in 1993-99, i.e., an average growth rate of 4% with a rate of investment of about 20% of GDP (Andersen, Ho and Mihaljek, 2001). Since investment efficiency in the EU is considerably lower (with a rate of investment of 20% of GDP, the EU realised an average growth rate of only 2.5% pa during 1993-99), there are good prospects that Croatia will speed up its real convergence to the EU compared with the other CE countries if it increases the rate of investment in the mid-term.

The question that arises in this context is how the additional investment could be financed. Further reliance on foreign borrowing is limited by the high level of external indebtedness. It follows that it will be necessary to increase domestic saving. This, in turn, requires the development of domestic financial markets, which are still in their infancy in Croatia. Since the investment and domestic saving rates are highly correlated (Figure 2), the development of domestic financial markets would enable not only faster but also more stable economic growth, given that Croatia would no longer be so dependent on trends in the international capital market, over which, like all small countries, it has no control whatsoever.

What are the prospects for achieving the GDP growth necessary for the convergence of per capita income to the average of the less

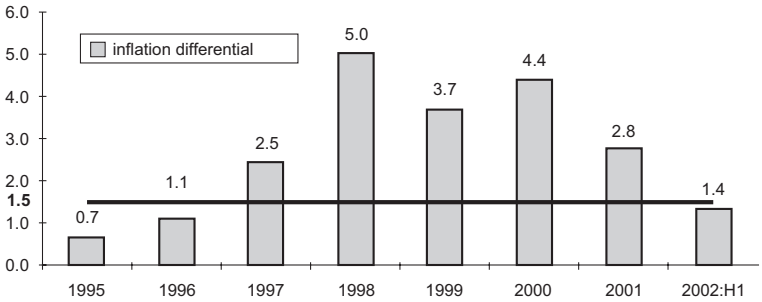
developed EU countries? The answer to this depends on the degree of convergence one wishes to achieve. In an earlier paper by this author it was shown that with an average growth rate of 5.5%, in the next 13 years, Croatia could double its current real per capita income to 10,000, USD and thus reach 50% (instead of 33% at present) of the average per capita income of Greece, Ireland, Portugal and Spain (Mihaljek, 2000). To verify whether this "desirable" growth rate is close to the current estimate of the potential growth rate, we used additional data for the period from the end of 1998 to the first quarter of 2002 (Figure 3). This test is important for the credibility of the previous estimates because in 1999 Croatia went through a recession, while in a revision of GDP data published in September 2002 earlier growth estimates for 1999-2001 were reduced. The results show that even with the recession of 1999 and downward revisions of GDP growth rates, the potential growth rate from 1994 to mid-2002 came to almost 5%.[xv] Similar potential growth rates were established for other CE countries as well (Table 4), and they range from 3.5% for the Czech Republic to 5-6% for Slovenia. Together with Slovakia and Slovenia, Croatia is thus in the group of the economies with the highest potential for long-term growth in CE.

Figure 3. Potential growth rate of the Croatian economy, 1994-2002.



Source: DZS; author's calculations

Figure 4. Difference in inflation rates Croatia vs. average of the three countries with lowest inflation in the euro area (percentages)



Source: ECB, HNB.

Outlook for inflation

Recent academic and policy discussions have challenged the rationale for the Maastricht criterion of inflation for the transition economies. Doubts about this criterion derive from the observation that less developed countries have a considerably higher growth rate of productivity in the process of catching up with the developed economies. Faster productivity growth, especially in the advanced sectors exposed to international competition ("tradables"), enables a rapid rise in wages and, since labour is mobile, wages will also rise in protected sectors (or "non-tradables", such as personal services, construction, domestic transport). In order to retain profitability, the less productive sectors are forced to increase the prices of their products, which results in a higher inflation than in the developed countries (assuming that the prices of advanced products are determined on the world market). In such conditions, if inflation resulting from the rapid productivity growth was relatively high, transition economies would be forced to increase interest rates and hence temporarily slow down economic growth in order to achieve the Maastricht criterion on inflation.

In empirical research it has been shown that the so-called differential productivity (difference between productivity in advanced and in protected sectors) has indeed risen very rapidly. In Croatia, differential productivity growth has averaged almost 4% per year (in comparison

with 1.8% in the Eurozone), and in Slovenia and the Czech Republic even higher (Mihaljek, 2002). However, most recent research has also shown that faster productivity growth can explain at most about 30% of the differences in the rates of inflation between the transition economies and the euro area (ibid., p. 17). Accordingly, if the CE countries have problems meeting the inflation criterion, the reason will probably be poor economic policy and not the operation of the Balassa-Samuelson effect.

Croatia for the time being meets the inflation criterion relatively comfortably in comparison with other CE countries; this criterion was fulfilled in the first half of 2002 and in 1995-1996 (Figure 4). However, it should not be forgotten that Croatia still has to cope with considerable adjustments of the relative prices in the protected sectors (energy, real estate, health care, education). Price increases in these sectors will probably raise inflation over the medium term. Therefore, there are strong reasons for monetary policy to remain prudent with regard to inflation.

External stability

According to standard external vulnerability indicators, the degree of external stability in Croatia is similar to that of other CE countries (Table 5). Croatia has certain advantages in the following indicators:

- *Exchange rate stability*. The real effective exchange rate of the kuna increased by less than 4% between 1995 and 2001, compared with a 25% increase for the Czech koruna and the Hungarian forint, almost 50% increase for the Polish zloty, and 20% increase for the Slovak koruna. Only the Slovenian tolar has depreciated in real effective terms (and then only slightly) in the last five years.
- *Improving exports and current account.* Contrary to the widespread beliefs, Croatian exports of goods and services have been rising relatively fast in the last few years: by almost 9% pa in dollar terms during 2000-2001, and about 3% in the first five months of 2002 due to the slowdown in the world economy. The current account balance has improved considerably, with the deficit of about 3% of GDP in 2001 being much lower than in the Czech Republic, Poland and Slovakia (5-6% of GDP).

Table 5. Indicators of external vulnerability

	Croatia		Czech R.		Hungary		Poland		Slovakia		Slovenia	
	1999	2001	1999	2001	1999	2001	1999	2001	1999	2001	1999	2001
Real effective exchange rate (1995=100)[1]	100.9	103.8	116.2	125.3	111.7	124.4	116.2	148.0	106.4	119.1	100.0	97.7
Exports of goods and services (%)[2,3]	-0.5	8.8	6.5	10.3	14.6	11.1	-1.0	-6.5	2.3	11.0	0.5	3.6
Imports of goods and sevices(%)[2,3]	-7.3	4.5	2.1	11.2	15.0	10.3	3.3	-4.0	-1.7	12.9	3.8	0.0
Current account deficit (% GDP-a)[3]	-6.9	-3.1	-2.4	-5.0	-4.6	-2.5	-5.9	-5.2	-7.1	-6.1	-2.4	-1.9
Foreign direct investement (% GDP-a)[3]	5.6	6.2	8.7	9.2	3.0	4.1	3.7	4.5	0.7	4.6	1.2	1.4
Net official reserves (billion USD)	2.8	4.5	12.8	13.9	10.8	10.7	26.4	25.7	3.4	4.2	2.5	3.5
Net official reserves (months of imports)	3.4	5.1	4.2	3.8	4.2	3.4	5.8	5.1	3.1	3.0	3.3	4.6
Total external debt (billion USD)	8.9	10.5	22.6	21.7	29.1	32.9	65.4	69.7	10.5	11.4	5.4	6.7
Total external debt (% GDP-a)	49.3	55.9	43.2	36.5	64.5	65.1	42.2	40.2	52.1	55.8	26.9	36.1
External debt service (% exports)[4]	22.4	19.6	12.7	8.6	15.9	14.7	11.8	20.9	15.4	14.6	8.0	14.7
Short term external debt (%reserves)[5]	83.5	60.4	66.4	63.4	38.0	51.8	41.1	35.6	79.0	71.7	3.7	2.9
Interest rate spread on government bonds[6]	407	187	128	97	123	119	101	164	36	113	71	43
Government bond rating[7]	Baa3	Baa3	Baa1	Baa1	Baa1	A3	Baa1	Baa1	Ba1	Baa3	A3	A2

[1] Based on CPI (for Croatia, retail prices); annual average. Increase denotes appreciation.
[2] Annual average growth of exports and imports in US dollar terms.
[3] Average for 1998–99 and 2000–01, respectively.
[4] Principal and interest payments on total external debt, in percent of exports of goods and non-factor services.
[5] Principal and interest payments on short-term (less than one year) external debt, in percent of gross usable reserves.
[6] Between dollar-denominated bonds and corresponding US Treasury bonds, in percentage points, end of period.
[7] Based on Moody's ratings of long-term foreign currency denominated government bonds.

Sources: BIS; UN Economic Commission for Europe; ECB; Institute of International Finance; IMF; central banks; national statistical agencies; Moody's Investment Service; author's calculations

- *Relatively large inflows of foreign direct investment (FID)*. As in other CE countries, the current account deficit in Croatia has been easily covered by FDI inflows. Moreover, FDI has increased in Croatia in recent years to 6.2% of GDP, larger amounts having been drawn in only by the Czech Republic (9.2% of GDP).
- *High official reserves*. At the end of 2001, disposable foreign currency reserves of the CNB covered more than five months of imports of goods and services, the same as in Poland. In 2002, the import coverage rose to 6.7 months, the highest in the region. High foreign currency reserves along with low inflation, a sound growth in exports and further foreign direct investment provide solid insurance for continued exchange rate stability.

However, foreign indebtedness and credit rating indicators are less favourable than those of the other CE countries, with the exception of Slovakia.

- *Total foreign debt as percentage of GDP* is the second highest in the region and came to 56% of GDP at the end of 2001; only Hungary was more indebted (65% of GDP). A particular concern is the tendency for the external debt to increase rapidly, by 7% of GDP during 1999 and 2001. The external debt increased at a faster pace only in Slovenia in this period (i.e., by 9% of GDP); however, this increase occurred from a much lower level of total debt (36% of GDP). The structure of foreign debt in terms of domestic sectors is relatively even. The public sector is the biggest debtor (43% of total foreign debt); followed by the non-financial sector (27%) and domestic commercial banks (19%); while 10% of the foreign debt derives from direct investment. This debt structure leaves some room for the reduction of the total level of indebtedness in the medium term without any negative consequences to economic growth. For example, while lower public debt is necessary for the sake of attaining fiscal sustainability and the reinforcement of external stability, the private sector debt and indebtedness deriving from foreign direct investment can be increased without any threat to macroeconomic and external stability.
- *Capacity to repay the foreign debt* is lower than in the other CE countries except in Poland, as 20% of export income has to be used for principal and interest payments, as against 15% in Hungary, Slovakia and Slovenia, and less than 9% in the Czech Republic.

- *The coverage of short-term foreign debt by foreign currency reserves* is relatively low: foreign debt falling due within one year would absorb 60% of disposable international reserves of the CNB if the public and the private sector were to become insolvent. This indicator is even more unfavourable in the Czech Republic and Slovakia (75-80% of reserves) and reveals potential problems with the servicing of short-term debt in the event of a sudden depreciation of the domestic currency. The Czech Republic and Slovakia, however, have greater capacities to service the foreign debt.
- Although in the last few years the *spread on Croatian government bonds* has been reduced, it is still considerably above the average for the region: about 190 basis points (1.9 percentage points) in compared to only 40 basis points in Slovenia and 100-120 points in the Czech Republic, Hungary and Slovakia. This shows that foreign investors continue to have certain reservations about the credibility of the overall economic policy of the Croatian government. Along with Slovakia, the credit rating of the government debt of Croatia is the lowest in the region, and lies at the border between speculative and mature forms of investment. By contrast, the government bonds of Slovenia and Hungary are considered investment grade, entailing a risk similar to that of the bonds of most of the countries of the EU.[xvi] A further negative factor is that the credit rating of Croatia has not improved since it was first quoted in January 1997, while the ratings of Hungary and Slovenia have improved since 1999.

What are the implications of these vulnerabilities for the sustainability of external equilibrium in the medium term? The needs for the external financing of the private and public sector in Croatia in 2002-2004 are estimated at about 3 billion USD pa (IMF, 2002a; 25). It is anticipated that about 60% of new debt will be covered by the issue of bonds and contracting of medium and long-term loans (for which the interest on the government bonds serves as a reference). With the current rate of interest of 4.6% on a ten-year German government bond and an interest spread of 190 points for Croatian government bonds, about 97 million USD would have to be spent each year on servicing the new borrowings projected for 2002–04. If the interest spread increased by one percent (100 points), because of the perception of increased risk of investing in Croatia, servicing would cost another 15 million USD pa. This amount, of course, would not threaten Croatia's external stability, but it is not insignificant for public finances: 15 million USD amounts to almost 10% of the annual budgetary resources spent on science and technology.

During a crisis, the bond spread would probably not increase by a hundred but by several hundred basis points. At the time of the Russian crisis in 1998, for instance, the spread on the bonds of the Republic of Croatia jumped in less than two months from 200 to 930 basis points. Under such circumstances, new borrowing is impossible regardless of the interest rate, because international investors seek liquidity and are not at all prepared to invest in risky securities. New issues markets can dry up completely for several months, with serious consequences for the highly indebted emerging economies. Developments since the Turkish and Argentine crises of 2001-2002 indicate that investors in the meantime have started to distinguish better those economies that are good risks from those that are bad, so that extreme cases of contagion on the financial markets (like the Asian and Russian crises of 1997-1998) are generally no longer expected (see BIS, 2002). For Croatia this is good news because currently it has found favour with foreign investors. But at the same time one should bear in mind that, given the greater ability of investors to distinguish among emerging economies, any threats to macroeconomic stability would be costly for the Croatian economy and would have long-term negative consequences for economic development.

The budget deficit and the public debt

Apart from Croatia, the CE countries were closer to having a budget deficit of 3% of GDP in 1999 than in 2001 (Table 3). The chances for 2002 and the years to come are even less favourable. A moderate revival of the world economy is expected only later in 2003. On the other hand, the needs of the public sector in central European economies are very large in the medium term because of the necessary adjustments in the health care, education, pensions system, infrastructure, agriculture and environmental protection sectors. All this will create a pressure on the budgets of central governments and local units in both Croatia and the other CE countries. The Czech Republic is expected, for instance, to record a budget deficit in the region of 6-7% of GDP in 2002, and Hungary of 7-8%.

Some public finance experts have argued that reducing the budget deficit is essentially a matter of political will, and have referred to the experience of Italy, which has managed to reduce its long-standing deficits of 9-10% of GDP to less than 3% since 1997 (Gros, 2001).

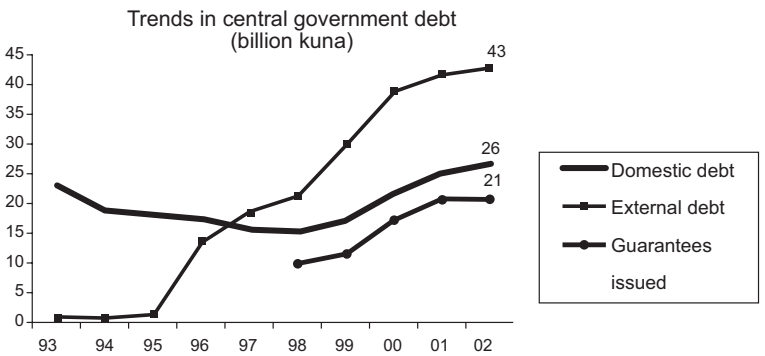
The case of Italy is, however, rather specific. Extensive development of a welfare state and economic subsidies can be reduced in the short term without negative consequences for growth, but not the expenditures for structural reforms necessary for long-term sustainable growth in the transition economies. The European Commission has therefore argued that in the period before joining the EU it would be wrong to aim fiscal policy at the attainment of the Maastricht criterion for budget deficit while neglecting structural reforms and the implementation of the acquis (European Commission, 2001e; 126). The financial markets, on the other hand, look upon large deficits with suspicion, irrespective of the possible justification of temporarily higher deficits in the transition economies. As a result, there is considerable market pressure to reduce high deficits. Croatia and many other CE countries will thus have to choose between alternatives that are politically equally unattractive: a significant fiscal adjustment in the short term (e.g., reducing the deficit by 3–4% of GDP in two years), or more moderate but disciplined adjustment spread out over several years (e.g., reduction of the budget deficit by 1% of GDP during 3–4 consecutive years), which in practice can mean during the term of office of several different governments. In both cases the key question will be whether the reduction of the deficit is sustainable over the long term.

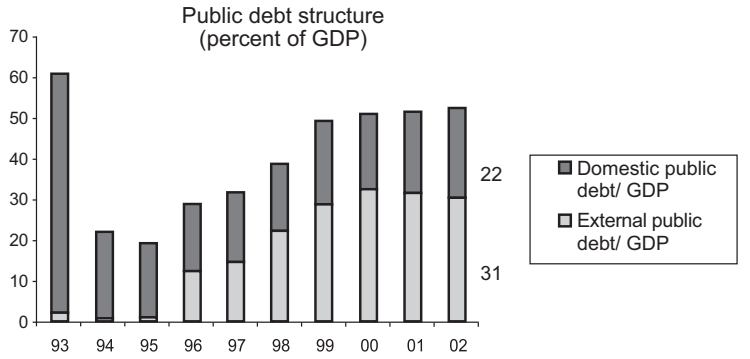
In Croatia, retaining public debt below 60% of GDP could also require considerable efforts. Since the signing of the agreements with the London and Paris Clubs in 1997, which allowed the settlement of the liabilities of the inherited foreign debt, the public debt, and particularly its foreign component, has been growing very rapidly (Figure 5, left panel). Between 1999 and 2001, the amount of guarantees issued also rose considerably. Debt servicing absorbed about 2% of GDP in recent years. The proportions of foreign and internal debt stabilised in 2001 at the level of 31% and 22% of GDP, respectively (Figure 5, right panel). In an analysis of the dynamics of public debt in Croatia, the IMF noted that the continuation of the current trends of borrowing is unsustainable over the long term, and hence that it is unavoidable to continue with recently initiated fiscal adjustment (IMF, 2002c). A similar conclusion has been reached in a recent CNB analysis (Kraft and Stučka, 2002). The IMF estimates that in order for the public debt to stabilise at 53% of GDP, it is necessary to reduce the budget deficit to 3.8% of GDP by 2005 at the latest, while maintaining real growth of 3.8% pa and average interest rate of 5%. And in order for the level of the debt to be reduced long-term to less than 50% of GDP, the budget

deficit should be cut to 3.3% of GDP by 2004, and to 2.6% by 2009. This calculation, however, assumes an acceleration of the rate of growth from 4.5% in 2003 to as much as 7% in 2006-2010, which is unrealistic when compared with the estimated potential growth rate of at most 5-6%.

What are the dangers, from a macroeconomic perspective, of too great a reliance on foreign borrowing? Currently the conditions for borrowing are favourable. On the international capital market, interest rates are low; Croatia and other countries in the region have a very low interest spread; and there is investor demand for their government bonds. This, naturally, encourages the public sector to borrow. But one should take into account the fact that the conditions for financing can quickly change. High indebtedness increases the sensitivity of the external sector and the national budget to exchange rate and international interest rate changes, over which the monetary authorities have little (the exchange rate) or no influence (the interest rates). Numerous unfavourable constellations of these parameters are possible: pressure on the exchange rate to depreciate would increase the domestic currency equivalent of interest and principal payments due, and hence the budget deficit. The government would then have to increase taxes or domestic interest rates in order to bring in extra revenue, or else issue new domestic bonds, which would slow the economy. Weaker outlook for growth would in turn increase the risk of investment in Croatia, and foreign investors would then seek higher interest on any new international issues of government bonds. Real shocks such as a slowdown in the growth of the world economy and negative trends in international capital markets would further complicate such negative dynamics.[xvii]

Figure 5. Central government debt, 1993-2002





Source: HNB

Excessive reliance on external debt also has an unfavourable effect on the development of domestic financial markets. The ratio of foreign and internal debt is currently unfavourable: 62% is accounted for by foreign and 38% by domestic public debt. Since the start of the pension reforms, there is no reason for this ratio not to be improved. According to regulations, the pensions funds must invest the major part (50%) of the contributions collected in government bonds. Against this background, it is not clear why the recent 500 million euro bond issue to cover the transitional costs of pensions reform should have been in euros instead of in kuna (see Babić, 2002). By issuing its bonds in a foreign currency, the fiscal authorities took on an unnecessary currency risk, increased total foreign indebtedness and implicitly signalled to the financial markets that not even the government has sufficient confidence in the kuna to issue long-term kuna-denominated bonds. This might affect in particular the private sector, given the interest in and the potential for issuing corporate bonds in kuna.

CONCLUSION

The Croatian public has been faced for some time with rather different views of the complex and long-lasting process of convergence between Croatia and European economic integrations. In some circles, a marked pessimism can be felt, with occasional knee-jerk statements about the incompetence of the Croatian economy, the public adminis-

tration and the society as a whole to be able to meet the conditions for membership in the EU and the EMU in the next ten to fifteen years. In other circles, unrealistic expectations about fast-track approach to the EU are being stirred up, if only we could make this or that political move to convince Brussels that we should at long last be accepted "where we really belong". The adoption of such opposing viewpoints avoids a thorough analysis of conditions for membership in the EU and EMU, and the conditions are interpreted quite simply as being very rigid or only cosmetic. Another common feature of many evaluations is superficiality in the analysis of the starting position of Croatia as against the other applicant countries. For this reason one of the basic goals of this paper was to analyse more thoroughly the economic significance of the criteria for membership in the EU and EMU and objectively to compare the initial positions of Croatia and the other CE countries. For this reason great attention has been paid to the international comparability of the statistical data and the preciseness of the economic argumentation. What are the basic conclusions of this analysis?

The rationale for the provisions concerning regional co-operation – the main additional (as compared with the other CE countries) condition for Croatian membership in the EU – is to induce the states in SEE to put their relationships on the same footing and to found these relations on the same principles as those on which inter-state relations are arranged within the EU. In spite of important advances (particularly bilateral free trade agreements), Croatia still needs to show that it is fulfilling all the provisions on regional cooperation.

The purpose of meeting the Copenhagen criteria is to create the conditions for normal functioning of market economy and public administration in CE countries before they join the EU. A certain flexibility has been built into these conditions. At the moment, Croatia does not lag significantly behind the CE average when it comes to institutional development and can be compared with Slovakia. In trade foreign exchange and banking systems, Croatia has converged considerably to the EU standards. In the non-bank financial system, competition policy, the legal system and in corporate governance, the implementation of reforms in Croatia is about four years behind the central European average. These transitional weaknesses of Croatia are closely related to the low share of private sector in GDP (about 60%).

The purpose of fulfilling the Maastricht criteria is to create stable macroeconomic conditions for the adoption of common currency and participation in European Monetary Union as a higher degree of eco-

nomic integration than that of the common market. Although they have to meet more stringent criteria for joining the EMU than Greece, Ireland, Portugal and Spain did in the mid-nineties, the CE countries are now relatively close to meeting these conditions. Croatia meets the criteria for inflation, long-term interest rate and exchange rate stability. However, there is considerable overshooting of the budget deficit, which has to be reduced by 3.5% of GDP in order to reach the Maastricht norm of 3%. The high level of public debt (52% of GDP) and its tendency to rise rapidly are an additional reason for fiscal adjustment.

The purpose of the whole process of convergence is to achieve a gradual approximation of the level of per capita income of the countries in the region to the average of the less developed members of the EU. Real convergence can be attained only with high rates of growth are sustained in the long term, i.e., if they are accompanied by macroeconomic stability and institutional effectiveness. In other words, meeting the criteria for joining the EU and the EMU is a necessary but not sufficient condition for successful long-term economic development. It is particularly important to bear in mind that hopes about sustained convergence can suddenly and unexpectedly turn sour. For this reason, the paper pays additional attention to the prospects for rapid and stable growth and low inflation, the sustainability of external positions and the problem of fiscal adjustment.

The outlook for the long-term growth of Croatia and CE is favourable: the potential growth rates in most of the countries are about 5% a year and there is plenty of room to speed up real convergence because, apart from the Polish, all the CE economies have in the last 7 to 8 years grown more slowly than their long-term potential. Croatia is in the group of economies with a high growth potential and has in additional achieved relatively high efficiency of investment. In this context, Croatia needs to increase domestic saving rate. This will require greater efforts in the development of the securities market and reducing the dependence of the economy on the imports of intermediate industrial products, which in turn requires the development of SMEs on the principle of specialisation and their linkage with foreign partners.

In the CE countries and in Croatia in particular inflation has been reduced to a very low level thanks to a firm monetary policy, cautious fiscal policy and liberalisation of foreign trade and foreign investment. In the next few years, however, Croatia still has to address considerable adjustment of the relative prices of energy, rents, services, health care and education. For this reason monetary policy in the medi-

um term too will have to carefully monitor inflationary expectations and react quickly to inflationary pressures.

Real exchange rate developments, current account, foreign direct investments and some other external sector indicators have in recent years been more favourable than is usually suggested in discussions of the international competitiveness of the Croatian economy. By contrast, some financial indicators that are often given as Croatian strong points – the credit rating and the interest spread on government bonds – are less propitious than in the CE countries. Together with a high level of foreign debt (52% of GDP, of which almost half is the public sector debt), these vulnerabilities reduce the resistance of the external sector to pressures emanating from the international capital markets. Therefore, strengthening macroeconomic stability remains a priority from an external perspective, too.

A still greater challenge for macroeconomic policy and the public sector in general will be found in the reduction of the budget deficit and the stabilisation of public debt. Achieving these objectives will require a much political will and perseverance.

There are, of course, other limitations that have not been discussed separately in this paper but could slow the Croatian economy in its achievement of nominal and real convergence. This relates primarily to the high rate of unemployment, the further deregulation and liberalisation of the economy in line with EU legislation, and reforms of the labour market and the civil service. If there is one consistent lesson to be learned from the experience of countries that have passed through the process of convergence with the EU – and indeed from the entire historical experience of the industrial countries – it is the necessity of persevering in the implementation of reforms and in the cautious handling of macroeconomic policy.

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[i] *Hungary, for example, signed a Europe Agreement in December 1991 and submitted an application for membership in March 1994. In July 1997 the European Commission recommended the European Council to start accession negotiations with Hungary (European Commission, 1997). The talks started in March 1998 and ended in October 2002.*

[ii] *Croatia can export all industrial goods to the EU, all processed agricultural products and, with certain exceptions, all agricultural products without payment of customs duties and without quantity restrictions. From 1 January 2002 Croatia liberalised the import of about 77% of industrial products from the EU; complete import liberalisation is to follow by the end of 2007. Croatia also bound itself to liberalise 75% of the import of agricultural goods by 2006, and to fully liberalise the import of agricultural products, fish and fish products, by the end of 2007.*

[iii] *The last paragraph of the Agreement says: Recalling the European Union's readiness to integrate to the fullest possible extent the Republic of Croatia into the political and economic mainstream of Europe and its status as a potential candidate for EU membership on the basis of the Treaty on European Union and fulfilment of the criteria defined by the European Council in June 1993, subject to successful implementation of this Agreement, notably regarding regional cooperation, the EU and Croatia have agreed as follows.*

[iv] *For various interpretations of the evolutionary clause, see the Ministry of European Integration (www.mei.hr) and Bartlett (2002). Of particular interest is this quote from the report of the European Integration Minister to the Croatian Parliament in 2001: "although there is no provision in our Agreement like that contained in the Europe Agreements, expressing the statement of the EU that it accepts the fact that integration into the EU is the priority political objective of the countries that were signing the Europe Agreements and that the EU is ready to help them to achieve this objective, this does not in any way depict the Croatian route into Europe in a negative light. In debates about this matter (in which Croatia asked to have the said provisions incorporated into the SAA, without the proposal being accepted) it became clearer that the EU today, in the changed circumstances after the calming of the historical enthusiasm with which it wished to embrace the transitional countries after the fall of the Berlin Wall and communism in Europe, is less ready to open up great expectations at the drop of a hat and stir up the expectations of potential new applicants, until they themselves show their ability to carry out the obligations that lead them towards accomplishment of the standards and criteria of the EU. And the Union did not adopt this more reserved stance because of Croatia or against Croatia, but simply out of caution and the difficulties with which it sees and experiences the current greatest wave of enlargement" (Minister for European Integration, 2002).*

[v] *CARDS – Community Assistance for Reconstruction, Development and Stabilisation) is the main programme of financial and technical assistance from the EU to the countries of SEE.*

[vi] *At the end of 2001, the public debt of Austria amounted to 62% of GDP, that of Belgium to 108%, Greece 100%, Italy 109% and the Netherlands 53%.*

[vii] *The relatively high per capita income of Greece in 1981 largely reflected the overvalued exchange rate of the drachma; after devaluation in 1982, the Greek per capita income fell from 63% to 40% of the EU average.*

[viii] *These data include downward revisions of GDP growth in Croatia for the 1999-2001 period, published at the end of September 2002.*

[ix] *Lower employment was not the main reason for the rapid growth in productivity; because of the relatively high rate of growth of GDP, productivity would have increased rapidly (at a rate of 3.6% pa) even assuming a rate of unemployment similar to the CE country average (i.e., about 0.4% pa).*

[x] *Unemployment figures are based on ILO methodology, i.e., household labour force surveys.*

[xi] *For the greater statistical representativeness of the sample, apart from the countries in Table 2 (Croatia, HR; Czech Republic, CZ; Hungary, HU; Poland, PL; Slovakia, SK and Slovenia, SI), this calculation also includes the Baltic countries (Estonia, EE; Latvia, LV; Lithuania, LT), Bulgaria (BG), Romania (RO), Russia (Russia) and the Ukraine (UA).*

[xii] *Data in Table 3 refer to the general government deficit calculated on accruals basis. The Croatian public is more familiar with the narrow definition of budget deficit, i.e., the*

deficit of the central government. In 1999, the central government deficit amounted to 7.4% of GDP, in 2000 it was reduced to 5.7%, in 2001 to 5.4%,and in 2002 it is projected at 4.3% of GDP.

[xiii] *In the system of national accounts, Y = C + G + I + X – M, where Y is gross domestic product, C private consumption, G government spending, I gross investment, X imports and M exports. Domestic saving, S, is expressed as S = Y – C – G. According to the definition, S – I = X – M, i.e., the shortfall in domestic saving is equivalent to the deficit in the balance of payments.*

[xiv] *See Statistical Yearbook of the Republic of Croatia, 2001, Table 21-5, p. 327.*

[xv] *To be more precise, potential growth rate was 8% in 1995, about 2% in the recession of 1999, and 4.5% in the first half of 2002. Potential growth rate changes depending on the growth of total factor productivity, production capacity and employment. The statistical method employed in Figure 3 (the Hodrick-Prescott filter) captures these factors indirectly. The 1991-1993 period is not relevant for analysis because the transition economies were in the so-called "great transformational recession" at the time, which was exacerbated in Croatia by the Homeland War.*

[xvi] *These ratings were established by the agencies Moody's, Standard and Poor's, and Fitch. Some smaller ratings agencies specialising in emerging markets have rated Croatian government bonds at the lowest level of investment grade.*

[xvii] *The difficulties Brazil is currently grappling with are a vivid illustration of these problems. In the expectation of presidential elections in October 2002, fears appeared on the financial markets already in April 2002 that if the opposition won, the new administration would give up the goal of the present government to stabilise the share of public debt in GDP. These fears were sufficient to set off a negative debt dynamics even though the government had made no policy mistakes and the real fundamentals of Brazil have been sound. Brazil's public debt amounts to 55% of GDP, and is mostly issued on the domestic market, but indexed to the exchange rate or domestic short-term interest rates.*

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Chapter 3

BANKING AND FINANCIAL MATTERS ON CROATIA'S ROAD TO THE EUROPEAN UNION

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ABSTRACT

The ability of a country to meet the criteria for financial convergence on the EU depends on four key factors: the behaviour and structure of the banks and non-banking financial service providers, the degree of development of the money and capital markets, the regulatory environment and the openness of the country to international financial currents. In this work the factors that work in favour of a rapid accession by Croatia to the EU and those that are the key areas of vulnerability on the same road are identified. The first group of factors includes the developmental level of the banking system, whose structural characteristics (competitiveness, ownership structure and scope of financial mediation) work in favour of rapid integration. This group also includes the standardising regulatory framework, the changes in which over the last few years have brought Croatia very close to the standards of the EU. Non-banking financial service providers are relatively undeveloped; however, where the investment and pensions funds are concerned, their development and the regulatory environment, rapidly converging on international standards, guarantee imminent ability to be included in the integration processes. The main areas of vulnerability are the undeveloped share capital market and a restrictive attitude with respect to international financial flows.

Key words:
financial market, capital market, convergence on the EU,
international capital flows, banking system

INTRODUCTION

The financial issues on some country's road towards the EU are usually brought down to those of whether the country is converging in terms of the quantitative criteria of Maastricht (amount of inflation, interest rates, public debt, fiscal deficit, currency stability). Sometimes the issue of the harmonisation of the standards with the legislation of the EU is highlighted. However, the most essential capacity of a certain country to meet the financial and associated standardising parameters of the EU depends primarily on the structure and behaviour of its institutions: the behaviour and structure of banks and non-banking financial services or institutions, the degree to which the money and capital market is developed; the regulatory environment and the openness of the country to international financial flows. In this paper we shall show that Croatia has the characteristics of an advanced country in connection with most of these criteria. A considerable lag can be noticed in the area of the development of the capital market and openness to international financial flows, which might in the future turn out to be serious sources of vulnerability in the process of Croatia's accession to the EU.

BEHAVIOUR AND STRUCTURE OF FINANCIAL SERVICES

The figures in Table 1 show a comparison of long-term interest rates in Croatia and in other transitional countries. Although the Maastricht criteria would tend to require a comparison of interest rates on long-term government bonds, the long-term interest rates on commercial bank loans shown in the paper demonstrate the ability of the banking system to mediate between the demand for and supply of financial resources, which belongs to the group of convergence criteria that are not measured by an unambiguously defined indicator. In spite of this, the competitiveness of the entire financial services sector is interpreted as an important structural precondition for EU membership.

Long-term interest rates in Croatian banks were greater than those in the Czech banks (among the transitional banks) as recently as the end of 2000. As against the average in the EMU, there was at that time a still

large 3 percentage points. Then the reduction of interest rates occurred, and they continued to converge on the European level. In the middle of 2002, these rates were almost completely the same as the Czech rates. They were larger than those in the EMU by only slightly more than one percentage point.

Table 1. Long-term interest rates charged by commercial banks on loans (%)

Country	2000	June 2002
Czech R.	8.1	6.6
Hungary	13.4	10.5
Polanda	21.4	13.8
Slovakia	9.6	9.8
Slovenia	18.4	15.5
EU	6.2	5.9
Croatia	9.3	7.1

Source: HNB

If one factors in the fact that inflation in Croatia is converging on EU criteria and that the trends in the exchange rate can already be interpreted as harmonisation with EU criteria (see Mihaljek's paper in this collection), fiscal issues remain the only really open financial questions on Croatia's road to the EU (Table 2). We shall not offer any separate debate on fiscal indicators here since they are handled in detail in the chapter of Mihaljek.

Table 2. Summary view of the outlook for meeting the Maastricht criteria

Criterion	Criterion met in 2001	Criterion expected to be met in 2002 or 2003	Long-term trend
Inflation	no	yes	good
Interest rate	no	yes	good
Exchange rate	yes	yes	good
Budgetary deficit	no	no	cannot be estimated*
Public debt	yes*	yes*	cannot be estimated*

** The methodological discrepancy of the fiscal accounts, especially of the accounts of the quasi-budgetary corporations such as HAC, Croatian Motorways, and the quasi-budgetary funds after 2000, and the failure to be up to date in the publication of the fiscal statistics (from August 2002 only the data from April were publicly available), make every attempt to estimate a long-term trend inadequately serious. Since the long-term trends in the public debt depend on the long-term trends in the budgetary deficit, the long-term trend of the public debt cannot be estimated, although its current level (around 40% of GDP, if government guarantees are not included, and more than 50% if they are) is still considerably below the level allowed according to the Maastricht criteria (60% of GDP).*

The measurable financial parameters should be looked at as the surface structure indicators of deep level power relations in society, which are reflected in the relations in the financial system. It is primarily the quality of institutions and the ability or inability of society to distinguish good and bad solutions in the creation of its economic and social policy that affect these relationships. These lines of force can be read off in the manner of regulating and running central banking, in the manner of regulating and running banking business operations. For this reason, in the sequel, there will be a brief discussion of the standard parameters that have to be satisfied on the road to the EU.

As for central banking, the independence of the central bank charged with the preservation of price stability is one of the fundamental principles of the Maastricht agreement. European institutions with justice insist on this rule, and recent attempts at changing existing laws in the central banks in the Polish and Hungarian parliaments created a fairly stormy reaction from the ECB.[i] Once again one should recall here that these are conditions that are more stringent than those that held good for countries like Spain, Portugal, Greece and Ireland in their EU accession processes. These states mainly adjusted the legislation governing central banking during the process of the formation of the EMU, that is, after they had already become members of the EU. Apart from that, today's applicant countries are faced with respecting a rigid standard. This fact need not be interpreted as the consequence of the deliberate application of double standards by the EU for applicant countries. The greater degree of stringency employed today is the consequence of the degree of finish and the enhanced stability of European standards and institutions as compared with the time when these countries joined. Then the European standards and institutions in the area of banking and monetary policy were largely in the process of being created, and gradual adjustment was the only possible approach.

The Croatian central bank law is on the whole harmonised with European standards to do with the definition of the objective of the central bank (low inflation), the availability of monetary policy instruments (prohibition on direct loans to the government) and the degree of central bank independence (total independence of the executive and limitation on the power of parliament to appoint and discharge the governor and his/her associates). For this reason it is necessary to resist any possible attempt to make inroads upon this standard, unless they are directed towards further strengthening of the independence of the central bank. The reasons for this should not be only of a formal and Eurocen-

tric nature; it always needs remembering that genuine central bank independence and low inflation belong among the basic, fundamental standards of modern market-economy democracies in Europe. Giving up on this standard will open up the Pandora's box of possible inflation, the harmfulness of which has been shown in this part of the world much more often than its rather dubious social benefits.

However, where banking and financial services in general are concerned, toughness in the standards that the applicant countries are expected to respect is much weaker than in the area of central banking regulation and the monitoring of macroeconomic indicators. The situation in the area of commercial banking is like that in the area of central banking of some 10 or 12 years ago. In general it can be said that the European standards are shown in a series of details of legislative solutions and byelaws and regulations. However, more important than the understanding of the regulatory particularities (to be discussed below) is the understanding that the possibility of the financial system's acting in line with European regulatory approaches depends on the degree of its development and its ability to withstand competition on the open market. From this point of view the Croatian banking system can be considered mature and competitive. This is reflected primarily in the amount of and trends in interest rates (Table 1). Other financial services providers, especially the pensions and investment funds have figured in any strength on the Croatian market only in the last two years, but the character and performance of their operations suggest a probable parallel evolution with the banking system, i.e., rapid convergence with EU criteria. Unlike the banks, these are financial services that previously did not exist in Croatia. Since there is no burden of entrenched institutions and regulatory approaches, from the very beginning they have been able to make use of approaches that are in line with international standards.

As for the investment and pensions funds, the European regulations have still not been rounded off, although with a fair degree of confidence it can be expected that some of the regulatory solutions will soon become obligatory on our funds industry as well. Perhaps the most important regulatory standard is GIPS, the *Global Investment Performance Standard,* which governs the transparent manner of comparing fund performance (manner and frequency of calculating the value of the fund, consolidation of similar funds run by the same management and determination of *benchmarks*, numerical criteria for performance comparison). Since this is not a standard that springs from the process of European unification but a standard that has been adopted, domestic

regulators (the Securities Commission) should start the process of importing it into the domestic market as soon as possible. In a similar manner, application of regulatory principles from Basel II should facilitate convergence of the standards framework for the banking industry on EU criteria.[ii]

Measurable financial indicators of harmonisation in standards constitute important criteria, but analysis of convergence with the EU has to go a step further and look more profoundly into the structure of the financial system, for it is on this that competitiveness in the European environment depends. In general, the degree of development of banking services is shown by the relation between banking assets and GDP. The figures in Table 3 show that Croatia is in the group of the most developed European countries, in terms of the banking industry, outside the EU. The Czech Republic has a considerably lower ratio of bank assets and GDP, and Slovakia and Slovenia have a negligibly higher ratio, among the group of countries we are comparing.[iii] It is also important to point out that a comparison with the EU is not relevant, for this average is affected by banking over-developed countries (especially Germany), in which there was a belated development of the non-banking financial services industry (primarily, investment and pensions funds) and of the share capital market, so that the development of the banking system there made up for the deficiencies in non-banking financial services providers. The comparison in Table 4 reveals that countries like Greece lurk below the European average, in which the banking system has not gone on any further than the group of (in banking terms) most advanced applicant countries, which Croatia is closing on. The ratio of banking depth (bank assets/GDP) shows that in 1993 Greece had a banking system at the developmental level of today's Slovakia and Slovenia, or only insignificantly above the other transitional countries with the most advanced banking systems. On the other hand, it should be borne in mind that this conclusion holds only in the comparison with Greece. The next-least developed EU state, Portugal, had a banking depth ratio of 132%, which is considerably more than today's ratio in the advanced transitional countries.

We can conclude that the banking systems in all the applicant countries and in Croatia, but not in Bulgaria, Romania and Lithuania, have reached the degree of development at which they can probably withstand joining the EU system. The relevant historical comparison that inevitably comes to mind to do with the ratio between banking

assets and GDP is that with Greece. A comparison with the next least developed EU country, Portugal, leads to the conclusion that there is a great difference between the banking systems of today's transitional countries and that of Portugal in 1993.

In the context of the debate about the competitiveness of the banking systems of the transitional countries, it is interesting to observe the shares of banks owned by foreign banks in total bank assets. Slovenia and Romania are the only applicant countries in which the share of the foreign banks did not, at the end of 2001, exceed 50% (although there are clear indications that there too this share will be reached very shortly). In all the other countries, this ratio is greater. In the CR, Estonia, Latvia, Lithuania, Slovakia and Croatia more than three quarters of banking assets are in foreign-owned banks. The internationalisation of the ownership structure will certainly make it easier to include local banking systems in the financial structure of the EU.[iv] Of course, debate about this necessarily enters the domain of speculation, because EU standards do not prescribe the ownership structures of the banks, and in the EU itself we meet, historically, very different kinds of ownership structure. The ownership structures shown in Greece and Portugal, where there is a negligible number of banks influenced by foreign owners, are typical of a large group of EU states. More recent comparisons, unfortunately, are impossible, because of the absence of any internationally comparable data; however the statistical research carried out by Demirguc-Kunt and Levine (1999) remains an invaluable source. In this dbase the data refer to 1997. On the basis of these data, it can be concluded that we can find an ownership structure like that of Greece and Portugal in Italy, Germany, Norway, Belgium, Sweden and Austria; it is necessary to bear in mind that these data do not reflect the proprietorial influence that the German banks have in Italy, nor the important changes that have occurred in the last five years, among which one should pick out the sale of Austria's biggest bank – Bank Austria – to Germany's HVB, which has fundamentally changed the proprietorial structure of the Austrian banking system. At the opposite pole, within the EU, there are countries with a highly internationalised structure of ownership in the banking system – Ireland, in which, as long ago as 1997, 66% of banks were foreign-owned, and Luxembourg, where foreigners own 58%. The proportion of foreign-owned banks in the UK varies constantly between 20 and 30% of total assets, while the corresponding share in the Netherlands fell to 33% in 1996, after having reached a maximum of 61% in 1992.[v]

Although trends and experiences of individual countries are different, a comparison of the development of ownership structures in the EU and in the transitional countries in the last ten years or so leads to the conclusion that at essence what is concerned is a globalisation process.

For this reason, the applicant countries will in the next few years be faced with problems very similar to those obtaining in the EU, which are:

- the incompleteness of the bank regulation system,
- the gradual exclusion of state ownership from the banking system,
- the public perception of loss of sovereignty because of the appearance of dominantly foreign ownership in the banking system.
- the accelerated development of non-banking financial services providers, particularly of the share capital market.

Table 3. Indicators of level of banking system development, 2001

Country	Bank assets / GDP (%)	Share of banks assets in foreign ownership (%)
Bulgaria	43	70
Czech R.	125	78
Estonia	73	97
Hungary	68	61
Latvia	73	97
Lithuania	33	81
Poland	70	51
Romania	31	39
Slovakia	94	75
Slovenia	94	33
EU	200	n.a.
Greece 2000	115	n.a.
Greece 1993	92	3*
Portugal 2000	203	n.a.
Portugal 1993	132	3*
Croatia	84	82

** Data relate to 1997 (Beck, Demirguc-Kunt and Levine, 1999).*

Source: Bank Austria Creditanstalt, International Financial Statistics, IMF, EBRD Transition Report

Since the globalisation process that results in accelerated financial development and transformation in ownership is common to both the countries of the EU and the applicant countries, the great struggle between the common and the national institutions about authority for the control of the banks within the EU is important for the peripheral countries beyond the borders of the EU. This struggle is being waged between the central banks, or the central supervisory agencies of the EU states (depending on who at the national level is charged with bank and other financial institution supervision) and the Eurocracy, which still does not have a clear view about whether oversight at the EU level should be carried out within the ECB, within the context of the independent-centralised supervisory institution or whether a compromise solution can be found, somewhere between centralising and national aspirations. For the moment, supervision of the banks has remained within national jurisdiction, but at Union level close international cooperation among regulators and supervisors of banks has started, because the operations of a single banks can no longer be supervised only at the centre (as witnessed to by the depiction of the changes in ownership structures and the increasing number of international agreements between financial regulators). The outcome of this tension between international and national control cannot at the moment be predicted even within the EU, and so it is unpredictable with respect to this country as well. In the words of a member of the Executive Committee of the ECB, Mr Tomasso Padoa-Schiopa, stated during a July address to the members of the Economic and Monetary Issues Committee of the EP in 2002, the achievement of unified rules and practices of bank supervision is the objective in the next three to four years. This is also the deadline by which the application of Basel II starts in the regulation of banks (see en ii), which, independently of the process of accession, will lead to the unification of regulatory standards and procedures. Accordingly, this is the temporal horizon within which there will certainly not be any consolidation of the supervisory authorities at the Union level. Europe moves slowly, but surely; and it has left the final answer to the question of regulatory sovereignty to the future political process that is of great importance to us.

Further, it is certain today that the state owned banks in the EU will not be able to obtain full licenses for all banking business. Since any more significant impact of the state-owned banks, particularly the state owned mortgage [hypothec] banks is felt precisely in Germany and Austria, changes in ownership structures here will have direct and

indirect impacts on banking in Croatia, through changes in the credit rating or ownership of certain banks the branches of which do business on our market. However, since the banks in the applicant countries are mainly internationalised and privatised, or well on the way to so being, some EU states will have much more difficulty in respect this EU norm than the applicant countries.

More important than this will be changes in the public mood with reference to "foreign banks". That is, public attitudes to the EU, globalisation and foreign ownership go, as a rule, through a number of phases. Initial rapture is followed by revulsion and disappointment, when the first problems appear, showing that there is no ideal system (this phase started in Croatia after the Rijeka banka crisis, which at the moment the scandal of foreign currency losses broke out was owned by a German state-owned bank). If the public gets cold feet at loss of sovereignty in the control of banks, it is easy to match this with arguments about essentially easier interest rates and loan conditions in an internationalised system and the vast costs that the taxpayer had to stand in the "national" system. However, bearing in mind Croatian political traditions, and the constant demand in them for stronger government interference in the economy, it is questionable whether any political elite will have any interest in preserving the achieved openness of the banking system if public pressure takes on greater dimensions than those we have seen to date. In the next few years the attitude of the public towards the opening of not only the banking system but of all segments of economic and social life will have to be attentively scrutinized. It is precisely in this attitude that the answer to the question of the possible speed of Croatian convergence on EU standards lies.

DEVELOPMENT OF THE CAPITAL MARKET

The fourth problem common to the EU and the applicant countries as well as Croatia relates to the inadequate development of the share capital market. In placing their resources, banks endeavour to minimise risks. The sources of resources of the banks are mainly not permanent (apart from their capital and the few long-term deposits)[vi], but are medium-term and short-term, which means that the banks have limited opportunities for term transformation as it is known for the sake of placing long-term funds. From this it derives that the

banks cannot be any kind of substitute for genuine investors, who do not put their money into debts but into capital, and thus take on much more risk, at the same time providing lasting resources for investment in corporate operations. In addition, trading in developed share capital markets provides a transparent price for share capital, which leads to its rapid migration from firms and sectors with low profit and dividend levels into firms and branches with high profits and dividends. This ultimately ensures the quality of the investment process and stable economic growth.

Although the share capital market is the core of capitalism, it cannot develop spontaneously. The development of it requires deliberate government intervention through the provision of a legislative, information and other infrastructure necessary for the functioning of an effective market. In this area, Europe is behind the US, UK and SE Asia, and the transitional countries have on the whole joined this old and inglorious European tradition. After the fall of the Wall, not enough attention was devoted to the development of the capital market. Instead of providing the legal and other kinds of infrastructure for the development of the market, the countries got directly involved in the privatisation process, contributing to what we now refer to as the crisis of "crony capitalism", which has essentially put at risk the credibility of the transition and capitalisation as the target system.[vii] In the first phase, government officials endeavoured to avoid, or carry out a very limited, allotment of shares. In the second phase, under pressure of high budgetary deficits, they resorted to the sale of the big state corporations to finance shortfalls in the budget. The essential elements of the development of a capital market, such as the passing of legislation, the establishment of capital market regulatory institutions (Securities Commission, Agency for Protection of Market Competition), privatisation of companies by private sale on the market, the establishment of cheap and efficient platforms for secondary trading all occurred sporadically and on the whole too late.[viii] Thus we arrived at the situation as shown in Table 5. The data show that Europe (as symbolised by Germany) is globally way behind the US, that the applicant countries (with the exception of Germany) range around the value of the indicator for Germany, while Croatia is quite clearly behind everyone, including the advanced applicant countries.[ix]

Table 5. Indicator of degree of development of share capital market

Country	Market capitalisation / GDP (%)
Czech R.	35
Hungary	56
Slovakia	24
Slovenia	27
Poland	17
Estonia	28
Lithuania	30
Latvia	7
Russia	26
Croatia	14
SAD	80
Germany	24

Source: Dalić (2002) and Šonje (2001)

There is a developed awareness in the EU of the importance of developing the capital market, as well as the fact that the fragmented national legislations and traditions are one of the main obstacles in the way of the development of an effective European capital market. In its action plan for financial services, worked out in 1999 and accepted in 2000, the EU mapped out the creation of a single European financial market by 2005, which primarily relates to the capital market. Unlike the EU, which has a clear target and determined deadlines, and unlike the more developed transitional countries like Hungary and CR, whose markets are relatively well developed for European conditions, Croatia[x], with one of the lowest ratios of market capitalisation, is right at the margin of global changes. The reasons need to be sought at several levels. First of all, privatisation in an unregulated environment, which relied on the self-managing and centralised state model, and not the model of allotment of shares, contributed to the dissemination of distrust and a feeling of injustice. Ultimately, it was not possible to create broad-based shareholding. Secondly, Croatia is a country that had fallen behind the advanced applicant countries in economic and business education, and understanding of the importance, manner of function and regulation of the capital market remained limited. Thirdly, in the Croatian economic elite, there is still the tradition of direct market intervention, which is not aimed at the developed of the market infrastructure, rather at the suspension or replacement of market mechanisms, which ultimately prevents the further development of a capital

market, because there is a tendency to look for alternative (administrative) mechanisms for the allocation of capital. As for the deep and lasting developmental obstacles, at this moment it is not clear how and in what period of time they can be overcome, and there is a danger that the lack of development of the share capital market will be an essential limiting factor in Croatian competitiveness during EU accession.[xi]

DEVELOPMENT OF THE REGULATORY ENVIRONMENT

The process of the transition in this country is on the whole understood as the process of the adjustment of standards to those of the developed market economy democracies. It is not a rarity for politicians (irrespective of party or background) to talk of changes in laws and standards as if they were goals in themselves. This is perhaps the reason why in Croatia, from the point of view of standards, there are no insuperable gaps with the advanced applicant countries for the EU, at least in the area of monetary policy and financial services. As we have already pointed out a few times in this paper, convergence in standards is important, but it is not a crucially determining factor in convergence with the EU, and hence we shall devote only a few lines to specifically legal issues, not letting slip of the fact that issues of standards are not any problem at all at the moment when the economic (structural), interest and socio-psychological lines of force are at work in conformity with the standards in the EU.

As already said, the CNB Law of 2001 is mainly harmonised with EU standards. In the process of passing it, the opinions of experts for central banking from the European Commission were made use of, in order to widen the understanding of the necessity of accepting certain standards, which is the first case of the kind in our legislative practice, as far as money and banking are concerned. Very likely this is one of the reasons why our Central Bank Law is already harmonised with the main normative parameters of the European Commission.

The new Banks Law conforms to EU standards to such a level that Croatia, with the amendments to this law and according to the definitions of some byelaws, certainly meets the requirements for EU membership. It is harmonised with the directives of the EU related to the starting of and carrying out the business of loan institutions, the

rehabilitation and liquidation of loan institutions, annual and consolidated report, capital adequacy and deposit security, to mention only a few of the most important areas. Since by 2005 Basel II will start to be applied, this will be an opportunity for a further step in convergence on EU standards.

Of course, there are many legal approaches that contain provisions that will have to be abolished or modified on the way to the EU (Law concerning Loan Business with Foreign Countries, the Inland Payments Clearing Law, the State Agency for the Security of Deposits and the Rehabilitation of Banks Law), just as there are legislative areas that are not sufficiently standardised in comparison with the EU (electronic financial business, security instruments, registers, regulation of financial conglomerates). However, these are areas in which, without any major problems, via laws or byelaws, convergence with EU can be achieved within the period for joining.

The only serious open area is that of foreign currency operations. This area will be treated in a separate chapter, because the current proposals for new solutions do not guarantee any progress on the road towards the EU.

OPENNESS TO THE FLOWS OF INTERNATIONAL CAPITAL

The degree of openness, and the dynamics of further opening up, to the flows of international capital are the most important elements of economic policy in a small and open country like Croatia. All the financial issues that we considered in the previous chapters essentially depend on how the country defines itself vis-à-vis international financial currents. An error in this area can cancel out the effects of an excellent monetary and financial policy, but at the same time, the effects of bad monetary and fiscal policies can largely annul an intelligent policy of opening up to international capital. The reason for such importance being ascribed to international financial flows is that foreign currency inflows and drains are a much more important determinant of changes of money supply (which is to a large extent of foreign origin), supply of loans, savings and economic activities than the monetary policy of one's own central bank.[xii] In other words, what for the USA is represented by Fed actions is in Croatia foreign currency flows.

Since in the EU accession process a greater degree of openness of the Croatian economy is to be expected, the anyway already important foreign currency issues will become even more important, for which reason they deserve a special place in this paper.

The current state of affairs in Croatia is such that we are very open to influxes of international capital, which is fine. Direct foreign investment and repatriation of profit have the same rights as domestic investment, the influx of foreign currency deposits is unrestricted,[xiii] and firms, banks and the government can borrow at foreign banks and on the international capital market. Certain forms of regulation do exist to do with the purchase of real estate (foreign natural persons can do this only with a special license) and of the usual reporting for the sake of the foreign debt statistics and the prevention of money laundering. On the outflow side, there are however many barriers. Citizens and firms may not have accounts with foreign banks (the corporate sector can, with special permission) or invest in foreign securities, and direct investments abroad can be made only be firms. The easy inflow and difficult outflow of capital make the current system asymmetrical and irrational, and the possibilities for the international diversification of portfolios are limited. In other words, the regulation system is created in such a way as artificially to create a larger supply of foreign currency in the country (and thus creating artificial pressure for the currency to appreciate) than that which would exist if the international currency flows were liberalised on the outflow side as well. The causes of this state of affairs should be sought in the heritage of the regulations from ex-Yugoslavia[xiv], in which the foreign currency legislation was written in such a way as to solve the constant problem of foreign currency shortage and to enhance the spread of government control over the economy.

However, the inherited regulations are not very distant from the standards that the EU at the moment requires from Croatia. During the four years after the signing of the SAA, i.e., by 2006, Croatia has to enable EU citizens free trade in land (apart form agricultural land, forests, nature reserves and the maritime zone) on conditions identical to those for Croatian citizens. Four years after the signing of the SAA, Croatia has to enable free portfolio investment and transactions relating to financial loans in a period of up to one year. The other conditions are already met in Croatia (convertibility on current account, freedom of direct foreign investment, free commercial loan transactions with a maturity period of longer than a year).

The conditions that the EU imposes on Croatia are similar to the inherited regulations in that they still deal more with the inflow than the outflow side. Probably this is one of the reasons because of which the proposal of the new Foreign Currency Business Law, of May 2002 (http://www.hnb.hr/propisi) are still based on a sceptical point of view with respect to liberalisation of international capital flows. The positive moves in the draft Law are mainly of a technical nature[xv] and the only essential new departure is the possibility of buying foreign securities. However, this too is limited to the government bonds of OECD countries, and it is hard to imagine any interest on the part of domestic investors for securities with low yields and low risk, because there are already plenty such securities and financial service providers that supply them (investment and pensions funds) on the domestic market. Still open is the question of how much the possibility of prescribing the lowest credit rating for foreign issuers whose bonds can be bought with restriction by residents will employed. In essence, the new foreign currency law has retained most of the outflow restrictions of the old law and in this way failed to inject some equilibrium into this sensitive part of the economic regulations.

A similar spirit prevailed with respect to the ability of foreigners to invest in Croatian securities. Non-residents may not invest in cashier bills of the CNB or in treasury bills, but may in other securities if the period maturity is longer than 6 months and if they retain them to the maturity period. In addition, the CNB may prescribe restrictions to do with terms and the possibility of making use of all short-term securities (Art. 26, Draft Foreign Currency Business Law). This restriction shows the nervousness of the government about the sudden movement of non-residents into short-term securities, which could equally rapidly be turned into a sudden outflow of capital. However, this fear is mainly without foundation, because:

- for quite a long time Croatia has had lower rates of interests and worse credit ratings than the applicant countries in this area, which means that short-term international money will probably give Croatia the miss for quite some time to come (it will tend towards areas with bigger yields and smaller risk), because at the moment there is no indication of any changes in these relations;
- because of its size Croatia will probably never be a main speculative target, for speculators for their operations required developed, large and liquid markets with low transaction costs of trading in financial

instruments. In much worse conditions, and with much higher interest rates, in the second half of the nineties, Croatia was exposed to the inflow of short-term capital, and this did not hurt it even then;
- the EU provides for the possibility that in the event of there being a major menace to the exchange rate policy and the balance of payments restrictions may be introduced. For this reason it is a mystery why restrictive measures and instruments have been incorporated into the law when they can be regulated by byelaws should a crisis make it necessary.

The possibility of intervening in the area of the freedom of the flows of international capital fits in with the well-known McKinnon theory (1991) of gradual liberalisation. It is important to note that the views advanced here are not an advocacy of unconditional liberalisation, rather the question is raised as to why those who proposed the new foreign currency law turned the reaction to an exceptional economic situation into a system that is built into the law. A more liberal wording of the law would not mean any ability to react to a crisis set off by changes in international capital movements. In addition, the beginning of the functioning of the economy in a financially liberated environment in the phase when the government can still occasionally intervene in the free market would be an important gain, because of the possibility of getting people used to an environment of the kind that awaits us in a few years time, but without the government being able to rescind individual freedoms. In this way the outflow side remains mainly closed, irrespective of the asymmetry that such a solution might create in the currency market (a possible structural excess in the supply of foreign currency), while functioning in a liberalised environment has been deferred to the moment when such liberalisation will be irreversible. We are perhaps missing a chance to get ready now for the total liberalisation that awaits us on entry into the EU.

CONCLUSION

Croatia can be satisfied with its tempo of convergence on the EU to do with the narrowly defined monetary indicators: inflation, interest rates and exchange rate. However, there is ground for concern in the indicators of the financial deficit that takes us essentially away from EU standards. The structure of the banking system, which is seen

in interest margins and in the internationalisation of the ownership structure, is very suitable for EU accession, and this evaluation can also be applied to the other financial services providers, which are integrated into the systems of international financial conglomerates. Nevertheless, the share market is worrying undeveloped in Croatia, and can in the long run be a serious developmental handicap which will limit the competitiveness of the Croatian economy in the EU. For this reason the creators of economic policy must undertake urgent actions in this area. As for convergence on the EU in the area of standards, we can be on the whole satisfied, especially with the central bank and commercial banks laws. This evaluation does not apply, however, to the area of foreign currency legislation. In this area a minimum of progress has been recorded since the emergence from the former Yugoslavia, and the draft of the new foreign currency law has let slip the opportunity for convergence with EU standards. The economic and financial systems will have gradually to adapt themselves to functioning in a liberalised environment. The retention of restrictive regulations to the last moment marks this area as the key area of vulnerability on the way to the EU.

RECOMMENDATIONS

- Make use of the introduction of Basel II for the adjustment of byelaws and regulations governing banking operations to the standards of the EU.
- Continue to affirm the independence of the central bank as an incontestable standard, and resist any unnecessary attempt to encroach upon it with the aim of diminishing central bank independence.
- Essentially step up the activities of the Republic of Croatia Securities Commission in the area of the European action plan for financial services and the introduction of international standards into the funds industry (GIPS, for example, *the Global Investment Performance Standard*).
- Design and implement measure for a more rapid development of the share capital market.
- Liberalise international capital flows, while retaining the possibility to restrict them in exceptional crisis conditions, instead of the current conception, according to which actual restrictions on international capital flows are retained.

[i] *The ECB and the Eurosystem (ECB and the central banks of the states members of the EMU) are not primarily political institutions and they have limited political influence. However, their political importance may not be underrated, not only because of their informal influence, but also because of the formal role of the ECB in making political decisions in the EU. The ECB provides opinions to the European Commission when it discusses financial and monetary issues, reports to the EP, and is directly involved in the economic dialogue between the EU and the applicant countries. The economic dialogue is coordinated by the European Commission. The objective of the economic dialogue is an exchange of opinions with the applicant countries in the pre-accession phase and preparation of them for reciprocal oversight procedures, which will be activated immediately after EU entry. For this reason great importance needs attaching to the fact that in the ECB Bulletin of July 2000, the following was written: In recent times, the parliaments of Hungary and Poland have debated draft amendments to the central bank laws, which would de facto reduce the degree of independence of the central banks. Acceptance of any amendments that, in essence, weaken the capacities of the central banks in their fight for price stability would give rise to serious concern in the EU accession process of these countries (ECB, July 2002).*

[ii] *The expert group for bank control at the BSI in Basel is constantly working on the unification of the so-called best practices in the regulation of banking systems in order to provide adequate and unified levels for the capital adequacy of the global banking system, which particularly relates to large international banks. After the first guidelines of 1988, the implementation of the second lot of guidelines is expected from 2005 only. The greatest changes being introduced refer to the acceptance of the influence of operational risks in the calculation of the capital needed, and greater reliance on internal rating systems of banks in the evaluation of lending risks (BIS, 2001).*

[iii] *The differences with respect to CR and Slovakia need to be interpreted provisionally. In the banking statistics of these countries, a good part of the bad assets are still shown in the balance sheets, which distorts comparisons with countries such as Croatia, in which banking balance sheets have been purged of bad assets.*

[iv] *Reporting procedures in the banking system are adapted to EU standards. Internal models for risk management and other operational procedures are on the whole adapted to EU standards under the influence of foreign owners and internal and external auditors. In general, the operations of international banks and firms have very positive external effects in the form of the spread of knowledge, procedures, business relations, morality and codes of conduct that prevail in the developed world. This effect need not be overemphasised, however, since local know-how and culture are the dominant determinations of the setting in which the foreigners are located. However, the influence should not be underrated either.*

[v] *Data from Spain are not available in this dbase.*

[vi] *Interbank long-term loans need not be looked upon as long-term sources at the level of the global consolidated banking system, because ultimately it can be financed only with capital, quasi-capital and long-term non-banking deposits.*

[vii] *Crony capitalism means a system in which capital is not controlled by the most competent who have managed to survive in the open market, but those who at the moment of privatisation were closes to the government officials who allocated the capital or those who through their influence on state intervention instruments managed to ensure better operating conditions for their firms.*

[viii] *For example, the two key regulatory institutions mentioned in the text started to be worked on in Croatia only in 1995/96, which means that the first phase of the transition and privatisation was carried out in a de facto unregulated environment.*

[ix] *The numerator of the ratio is the market value of share capital of a company placed on the stock exchange.*

[x] *The data need interpreting with caution because there is no internationally comparable and reliable dbase in which the share of capitalisation deriving from bonds is unambiguously set off from the part deriving from shares.*

[xi] *There is an alternative way of looking at the problem, taking off from the fact that Croatia is too small to be able to develop an independent capital market to any great extent. According to this viewpoint, the shares of the important firms will be quoted on the international capital markets when the firms are mature enough for this step. It would seem that the examples of Pliva and Zagrebacka banka speak in favour of this. However, there is still the problem of the manner of arriving at fresh capital for medium-sized firms that the international markets will not be interested in, or for which the transaction costs of issuing new shares on the international market will be prohibitively large.*

[xii] *This goes only for little countries. In big countries foreign currency inflows and outflows are relatively of lesser importance consider the GDP, and so the importance of domestic monetary and fiscal policy is incomparably greater.*

[xiii] *Unless we count as restriction the not very sensible obligation for every transaction worth more than 105,000 kuna, irrespective of whether it is in cash or not, has to be reported to the Prevention of Money Laundering Office.*

[xiv] *The currently valid foreign currency law was written in 1993, in a hurry, and with a single objective – the liberalisation of currency transactions (Article 8, Charter of the IMF). This provision was formally accepted two years later for formal reasons (Croatian had not yet settled its affairs with creditors relating to the debt inherited form the former SFRY), but de facto acceptance of this obligation occurred in October 1993.*

[xv] *The areas are:*

1. *governing the trade in gold in other instruments;*
2. *a liberal system of areas of direct foreign investment (no novelties, only the material is simply and systematically arrange din one spot;*
3. *government of the issue, classification and sale of the so-called Global Depository Receipts;*
4. *the government of the issue, classification and sale of foreign securities in the Republic of Croatia;*
5. *the superfluity of the Loan Business With Foreign Countries Law;*
6. *the possibilities of making long-term loans to non-residents.*

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Chapter 4

COMPARISON AND HARMONISATION OF THE CROATIAN TAX SYSTEM WITH THE TAX SYSTEMS IN THE EUROPEAN UNION

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ABSTRACT

This paper analyses the EU tax system and its main components qua conditions for the accession of the Croatia to the European Union as well as the current degree of adjustment of Croatian taxation regulations with the corresponding regulations in the EU. As a result of this analysis, proposals for further procedures on the part of the creators of taxation policy in Croatia are made. After the tax reforms started in the 1990s, after the achievement of independence, the Croatian tax system was comparable with the tax systems of EU member countries. All the essential taxes correspond conceptually to the same kinds of taxes in EU countries. However, there is still space for further adjustment, above all in connection with value added tax, and it is desirable that this should be carried out

as soon as possible. However, adjustments in the area of profit tax and adjustments of some rates of excise duties should be put off until the moment when they will have to be done for the sake of joining the Union, because the maintenance of the current situation, which is not in line with the provisions of European regulations, but nevertheless not in contravention of general rules regulating the area of taxation, is in the interests of Croatia. In the area of the taxation of income no adjustment or coordination is needed, for members are allowed to settle the taxation of income in their countries independently, as long as the fundamental principles of the single market are not threatened (the free movement of goods, people, services and capital).

Key words:
European Union, Croatia, taxes, profit tax, income tax, value added tax, excise duties, adjustment, harmonisation

INTRODUCTION

From its outset, the EU has been founded on the four freedoms, as they are called, the free movement of people, goods, services and capital, essential conditions for the existence and successful operation of the united European economic area. For this reason the basic tasks of the taxation policy of the EU in recent years have been tightly connected with the development of the internal market, the reinforcement of monetary union and economic integration. As far back as the early 1990s, the regulation of the internal market led to a definition of the legal framework for the area of indirect taxes (value added tax and excise duties) while in the area of direct taxes (income and profit tax) no legal background was clearly defined. For the improvement of the coordination and harmonisation of tax policy among the member countries, in 1997 the basic directions of tax policies were set out (COM (97) 495); these should encourage the stabilisation of member states' tax revenues, the obviation of difficulties in the functioning of the internal market, employment.

However, the disparateness of tax systems was a constant roadblock in the way of full accomplishment of these objectives, the solution of which has to be attained via continued harmonisation of the tax systems of the member countries. It has turned out, however, that this kind of harmonisation is very difficult to achieve in the area of taxation as a whole. Nevertheless, fairly significant results in the harmonisation of the diverse systems have been obtained in the area of indirect taxes. Within the framework of direct taxes, the effects have been much

weaker. Certain aspects in the area of the taxation of income are not anyway subject to harmonisation and every member has the discretionary right to regulate it in its own way, while certain results have been obtained in the area of profit tax.

The legal instruments for harmonisation among the members in the area of taxation are the directives. They are used to prescribe the settlement of certain relations, and members are obliged to put into their legislation provisions through which to achieve the objectives defined in the directives can be attained.

In the process of the approach to fully-fledged EU membership, Croatia should harmonise its legislation with that of the EU. For this reason, the purpose of this paper is to sketch out, in the most important lines, what happened in the 1990s with the tax systems of the EU, to what extent Croatia has already made adjustments to these changes, and what remains to be done.

This work is composed of six parts. After the introduction, in the second part the situation and trends in taxation in the EU and in Croatia are presented, in the third profit tax is discussed, in the fourth VAT, in the fifth excise duties, and the sixth part offers conclusions and recommendations.

TAXATION IN THE EU AND IN CROATIA: THE CURRENT SITUATION AND THE TRENDS

Tax revenue as a percentage of GDP

The objective of this paper is to offer a general overview of the basic trends of development and the current state of the tax systems of EU members. Because of limitations of space it is not possible to comment on all the diversity of the tax systems of the individual countries.[i] Thus only the most important and most marked changes of the last decade in the tax systems of the EU are shown, that is, the changes in tax revenue as percentage of GDP, in the structure of the tax systems, in the highest rates and the number of brackets for income tax, in the tax base and in the basic rates of profit tax and the standard rate for VAT.[ii]

During the 1990s, in most EU countries, there was a continuous rise in total tax revenues (including contributions) expressed as a percentage of GDP. For example tax revenue collected rose from 39% of GDP in 1990 to almost 42% of GDP in 1999 (Table 1). The reason for

this can be found mainly in the larger expenditures for health and retirement insurance and for public welfare (because of the ageing of the population) (Rosen, 1999: 18, 19). Also mentioned as causes for this increase are a rise in the interest rates, which means outgoings for the public debt, increased governmental aid for government owned corporations and the implementation of major public infrastructure projects (Joumard, 2001: 7).

Table 1. Total tax revenue as percentage of GDP

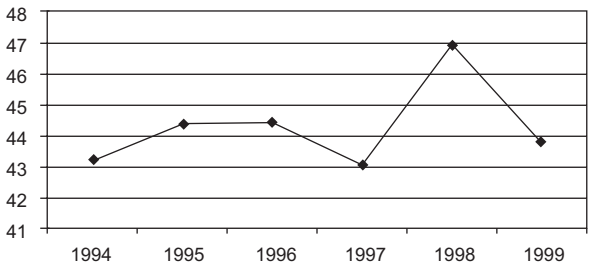
Unweighted average	1990	1995	1999
EU 15	39.2	40.0	41.6

Source: OECD (2001)

As against the clear picture of growth of total tax revenue as percentage of GDP in the EU countries, a glance at Graph 1 will not give a simple answer to the question about what was happening at the same time with total tax revenues as a percentage of GDP in Croatia. It is clear only that there was a large jump in the growth of tax revenue as percentage of GDP in 1998, when VAT was introduced. The introduction of VAT, that is, because of the expansion of the tax base and the reduction of tax evasion, led to a relatively large rise in the tax revenue expressed as a proportion of GDP.

From 1994 to 1999, tax revenues in Croatia came on average to about 44.3% of GDP. After a comparison of data for Croatia with equivalent data for the EU it can be said that throughout the whole of the period up to 1999, the total tax burden was greater in Croatia than in the countries of the EU.

Graph 1. Tax revenue as a percentage of GDP in Croatia from 1994-1999



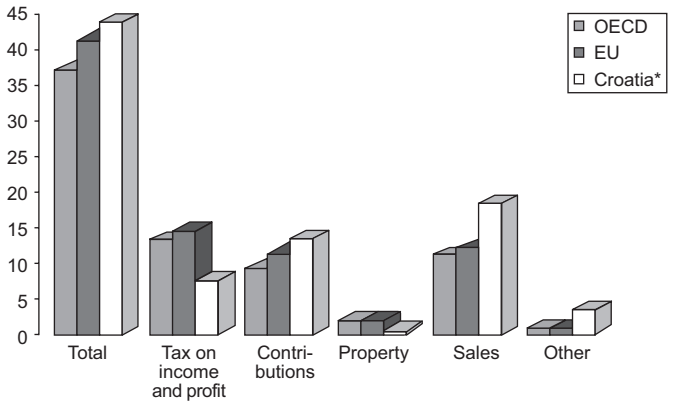
Source: MF Republic of Croatia (2001)

Tax structure

Messere (1997) states that in most industrial countries at the end of the 1980s and at the beginning of the 1990s, tax policy was mainly redirected from the taxation of income and profit to the taxation of consumption. For this reason a comparison of Croatia with the countries of the EU and the OECD, shown clearly in Graph 2, demonstrates that Croatia too is keeping up with this trend. In Croatia much less revenue is collected from income tax and profit tax and much more from sales tax. For example, in 1999 Croatia collected as much as 18.5% of GDP from turnover tax, and only 7.6% of GDP from income and profit tax.

It does not fit in with the trend towards redirecting taxation towards consumption only because Croatia collects the greatest amount via contributions: 13.6% of GDP in 1999 as against 11.4% in the EU in 1998. But from the beginning of the implementation of reforms in retirement and healthcare insurance, it is expected that obligatory contributions as share of GDP will start to fall (Kesner-Škreb, Kuliš, 2001).

Graph 2. Taxation as a percentage of GDP in 1998 total



** Croatia – data for 1999.*

Source: OECD (2000); MF, Republic of Croatia (2001)

Income tax

In most EU countries there was a cut in the highest rates of income tax and a reduction in the number of brackets for the taxation

of the income of natural persons, the objective being to lighten the tax burden on the income of natural persons. Sandford (2000) says that the reason for these reforms in the income tax system was the tendency to reduce the tax burden and improve the competitiveness of the economy and economic growth. Then he states reasons such as the achievement of greater equity and neutrality in the tax system. The reason for reducing the number of brackets is an attempt at simplifying income tax system and improving the efficiency of tax collection (Messere, 1998).

The results of reducing the highest rates of income tax and the reduction of the number of brackets in the taxation of natural persons in 2002 are shown in Table 2. The same table shows what the situation was in Croatia in 2002. Since a basic objective of the EU is the long-term reduction of the tax burden (European Commission, 2002b: 25), and in comparison with the unweighted average of EU countries Croatia has the lowest maximum rate of tax on income and the smallest number of tax brackets, it may be concluded that the rates and the number of income tax brackets in Croatia are thus harmonised with the aims of the EU.

Table 2. Rates of income tax in 2002

Country	Highest rate (%)	Number of brackets	Country	Highest rate (%)	Number of brackets
Austria	50	5	Ireland	42	2
Belgium	55	6	Luxembourg	38	17
Denmark	*	*	Netherlands	52	4
Finland	36	5	Spain	48	6
France	52,75	7	Portugal	40	6
Germany	48,5	4	Sweden	25	3
Greece	40	5	UK	40	3
Italy	45	5			
EU average					
14**	43.7	5.6	Croatia	35	3

** In Denmark there are no tax brackets, rather six different tax bases are taxed with different tax rates. The rates range from 5.5 to 30%.*
*** Unweighted average.*

Source: IBFD, 2002

Profit tax

Messere (1998) says that in the 1990s a broadening of the tax base was seen in the area of profit tax. The reason for this was in the abolition and reduction of the number of tax incentives, and the reduction of the basic rate of profit tax in most of the EU countries. In the short period in which the new tax system has existed, from 1994 until the present day, the profit tax rate has been reduced in Croatia, from 35 to 20%. From Table 3 it can be seen that in 2002 only Ireland within the EU had a lower rate of profit tax than Croatia. Since the basic objective of the EU is the long-term reduction of the tax burden, it would seem that, at least as far as the rate of profit tax is concerned, Croatia has achieved this objective better than most countries in the EU, and even before becoming a member.

Table 3. Basic rates of profit tax in 2002

Country	%	Country	%
Austria	34	Ireland	16
Belgium	39	Luxembourg	22
Denmark	30	Netherlands	34.5
Finland	29	Portugal	30
France	33.33	Spain	35
Germany	25	Sweden	28
Greece	37.5	UK	30
Italiy	36		
Average EU 15*	30.6	Croatia	20

** Unweighted average.*

Source: IBFD, 2002

Value added tax

During the 1990s there was a practically universal increase in the standard rates of VAT (Messere, 1998). VAT was introduced in Croatia in 1998 and there has been no change in the amount of the standard rate. However, there were changes in zero rate taxation (Ott et al., 2001). The key regulation in the EU in the area of the harmonisation of taxation of consumption via the implementation of a general consumption tax is the Sixth Directive, as it is called (for a detailed analysis of the harmonisation of VAT with the provisions of the Sixth Directive, see later in the text). Table 4 shows that in 2002 the standard rate of

VAT in Croatia (22%) was greater than the unweighted average for the 15 countries of the EU (19.47%).

Table 4. Standard rates of VAT (2002)

Country	%	Country	%
Austria	20	Ireland	21
Belgium	21	Luxembourg	15
Denmark	25	Netherland	19
Finland	22	Portugal	17
France	19.6	Spain	16
Germany	16	Sweden	25
Greece	18	UK	17.5
Italy	20		
Average EU 15*	19.47	Croatia	22

** Unweighted average.*

Source: IBFD, 2002

In conclusion, it can be stated that in the period from 1994 to 1999 the total tax burden in Croatia was greater than in the countries of the EU. For this reason it needs reducing, through reductions in contributions, which were greater in Croatia than the OECD countries. In the area of income tax and profit tax, the Croatian tax system is harmonised with the tax changes in the EU. Only for VAT are changes necessary in connection with tax exemptions.

PROFIT TAX

This section presents the state of the harmonisation of the tax systems of members in the area of profit tax, the particular problems of corporate taxation. One problem lies in the fact that dividends that a subsidiary firm from one member country of the EU pays to the main company in another EU member are taxed twice. Another problem is the double taxation burden that is the consequence of corporative restructuring of firms that are taxpayers in various different member countries.

The parent - subsidiary directive

When a subsidiary firm in a given state pays a dividend to its parent firm in a second state, two tax situations can arise in consequence:

- the dividend is subject to taxation in the state in which the subsidiary firm that pays out the dividend is located;
- the dividend that is obtained by the parent company is also the base for taxation of this dividend in the state in which the parent company is a taxpayer.

This double taxation prevents the free movement of capital, and the Directive is a measure through which this obstacle is removed. This is achieved by the prescription of obligatory procedures on the part of member countries towards corporations that are qualified to have the Directive applied to them.

Qualified corporations

These are those corporations that meet these conditions (Survey of the Implementation of the EC Corporate Tax Directives, 1995):

- takes one of the forms listed in the Annex to the Directive;
- according to the tax laws of a Member State they are considered a resident in that state for the tax purposes;
- are subject to one of the taxes listed in the Directive.

Two additional conditions are contained in Article 3:

- in order to be considered a parent or a subsidiary, a parent company must hold at least 25% of the capital of the subsidiary company, or at least 25% of the voting rights in the subsidiary company;
- a Member State may refuse to apply the privileges defined in the Directive if the parent company has not been the owner of 25% of the capital of the subsidiary company for at least two years uninterruptedly.

Methods for avoiding double taxation

Methods for avoiding the double taxation of dividends must be applied by both the country in which the taxpayer is the parent company and the country in which the taxpayer is the subsidiary company.

1. The Directive allows the country in which the taxpayer is the parent company a choice of methods (Terra and Wattel, 1993):

- non-taxation of a dividend that is paid by a subsidiary, or
- the taxation of a dividend that is paid out, with the parent company being authorised to deduct from its profit tax the amount of profit tax that has been paid by the subsidiary.

2. The country in which the taxpayer is the subsidiary must not tax the dividend the subsidiary pays to the parent in another EU member.

Merger directive

In many countries the consequence of mergers or reorganisations of corporations can be an increase in the tax liability, i.e., the occurrence of capital gains in connection with the increased value of the fixed and intangible assets and the possible loss of the amounts of tax losses that are carried forward. The task of the Directive is to obviate these obstacles if the merger, division or reorganisation is carried out among firms that are located in various different member countries. The objective is achieved in such a way that the liability to pay the tax is deferred until the sale of the assets to a third party.

The Directive defines four kinds of transactions to which the provisions about the deferral of taxation have to be applied (Terra and Wattel, 1993).

- Legal merger – one or more corporations transfer their assets and liabilities to some other corporation. The firm to which the assets and liabilities have been transferred issues new shares to the shareholders of the disappearing corporation(s) according to the "share for share" principle.
- An existing firm transfers all its assets and liabilities to two or more new or existing firms. The firm that has transferred its assets and liabilities ceases to exist. In exchange for the transferred assets and liabilities the company issues new shares to the shareholders of the defunct firm on the "share for share" principle.
- One corporation transfers all its operations to another firm or one or more branches are transferred to the parent company or another cor-

poration. Equity in the company to which the operations or the branch is transferred is given in exchange for these transfers.
- One corporation acquires a major holding in another firm from the owners of the equity in this other corporation. In return, the owners of the shares in the firm that has been obtained by the acquiring firm become shareholders in the acquiring firm (share swap) (Survey of the Implementation of the EC Corporate Tax Directives, 1995).

The working of the Directive

According to the provisions of the Mergers Directive, member states have to defer the taxation of capital gains arising in connection with the cross-border mergers described, but do not have to give up on taxing these gains altogether. After the firm to which the assets and liabilities have been transferred has alienated the assets, the difference between the sale price and the value of the assets can be taxed. Members may pass anti-evasion provisions annulling the privileges of the Directive if it is determined that one of the main objectives of the merger or the division is the legal or illegal evasion of tax liabilities.

Qualifyied firms

Like the Parent-Subsidiary Directive, the Merger Directive too provides for subjects to which it applies the deferral of the payment of taxes. In order to be able to claim this privilege, corporations must have the status of corporation of a Member State, i.e., have to meet certain conditions. These conditions are the same as in the Parent - Subsidiary Directive.

VALUE ADDED TAX

The provisions of the Sixth Directive are contained in the Croatian taxation law system, for VAT that is in terms of legal standards shaped according to the European model has been introduced into it.

The taxpayer, the tax base and the rate

In the regulation of the institutes of the taxpayer, base and rate, the Croatian Value Added Tax Act (known as ZPDV for short) is to a very high degree harmonised with the Sixth Directive. To do with the rate of tax, the Sixth Directive prescribes three levels: the standard rate, which may not be lower than 15%, one or two reduced rates, for goods specially stated in Annex H of the Directive, which may not be lower than 5%, and the zero rate. The original conception of the Croatian rules in the regulation of the tax rates, which meant a one-rate system, with a zero rate and refunding of pre-payment of tax, was theoretically even more consistent than the Sixth Directive. Before the alterations of the ZPDV passed in 1999, it was precisely the conception described that was applied. The introduction of a zero rate for the delivery of a certain number of goods, which was explained by social reasons and actually dictated by political pressures (the imminent parliamentary elections), made inroads in the theoretical consistency of the precious solution and also, more importantly, made the system of taxing sales more complex, and hence pushed.

Tax exemptions

An analysis of the harmonisation of the Croatian value added tax system with the provisions of the Sixth Directive shows that there are three groups of exemptions (Jelčić et al., 1999):

- tax exemptions in line with the provisions of the Sixth Directive (the rent of residential property)
- tax exemptions that are not consistent with the provisions of the Sixth Directive (banking services and insurance service),
- tax exemptions that are partially consistent with the provisions of the Sixth Directive (other exemptions inside the country).

Because the law on the exemption of the rental of residential premises in the Croatian taxation law system is harmonised with European solutions and hence is not a problem in the context of the project of which this paper is a part, the continuation of this text will be concerned with the exemptions stated in Items 2 and 3.

Banking and insurance services

The Sixth Directive prescribes that banking and insurance services be exempt from VAT, irrespective of who performs them. The ZPDV, however, prescribes tax exemptions for these services only if they are carried out by given institutions, that is, banks, savings banks and savings and loan organisations, insurance and reinsurance firms. From this, it derives that the Croatian approach, as compared with the Sixth Directive, is discriminatory towards firms that carry out these services without being one of those that are expressly exempt from the tax. Hence, this approach in Croatia should be harmonised with the solution found in the Sixth Directive.

Other inland exemptions

According to the Sixth Directive, all establishments that carry out the activities of organising special games of chance, preschool education, elementary, secondary and tertiary education, culture, health care, welfare and religious services have the right to be exempted from VAT. But subjects carrying out these activities in Croatia can claim the right to be exempted only if they have been founded according to the Institutions Act, and if they are financed from the Budget (Jelčić et al., 1999). In other words, institutions and communities in these activities founded by natural and legal entities in order to make a profit do not have the right to exemption (Jelčić et al., 1999). This makes a discriminatory approach standard, unlike the approach of the Sixth Directive. For this reason, without any additional conditions, all persons that carry out these activities should be exempted from VAT.

EXCISE DUTIES

This part will discuss taxation by excises (special sales taxes) in Croatia and in the EU. Because of the relatively large number of these taxes, the directives that relate to them are numerous, as proved by the complexity of the harmonisation process in the Union itself. Nevertheless, as in VAT, the Croatian tax system has conceptually not fallen behind the European model.

Excises in the EU and in Croatia

Although in the EU countries a varying number of products are taxed by excise duties, what is common to all countries is the taxation of alcoholic beverages and beer, tobacco products and mineral oils. There is an endeavour to standardize the tax structures via harmonisation, while the greatest lack of harmony can still be seen within the tax rates.

In the EU the taxation of alcoholic beverages, tobacco products and mineral oils is ordered by the general agreement for products subject to excise duty and on the holding, movement and monitoring of such products (92/12/EEC, 92/108/EEC, 94/74/EC, 96/99/EC). Members may retain already existing or introduce new excises on some other products, on condition that the movement of these products does not require special customs formality on border crossings and that these goods are allowed freedom of movement (including non-taxation by excise duties) in the cross-border trade among the members. This kind of freedom of movement is conditional upon the existence of bonded warehouses and appropriate customs/tax documents that have to accompany these products in cross-border trade. The basic principle is the taxation of these products in the consuming country according to the rates that are applied in this country. The agreement defines minimum rates, although there are considerable differences in the rates among the member countries, which creates a fair amount of difficulties in trade across the border (cross-border shopping smuggling).

As well as the need to harmonise the rates, it is also to a certain extent necessary to harmonise other essential questions of tax structure. Although a series of harmonisation documents have been passed and adopted (Committee on Excise Duties has been founded for the sake of implementing the common policy), in the future, especially because of the acceptance of new members, considerable efforts will have to be made so that any very great differences in the tax structures among the countries can be reduced to the smallest possible measure.

From 1994 to 1999, eight excises were introduced in Croatia (on coffee; mineral oils; alcohol and alcoholic beverages; tobacco products; beer; non alcoholic beverages; passenger cars; other vehicles; vessels and planes; luxury products). The number of excises in Croatia is considerably smaller than those in most of the countries of the EU, where in some of them up to 20 different products are taxed in this way (Denmark, France) (OECD, 2000).

Table 5. Total revenue from excise duties in 2000

	As percenage of total tax revenue	As percentage of GDP
EU	10.3	4.2
RC	18.9	4.8

Source: MF Republic of Croatia, 2002; OECD, 2002

This table shows that in Croatia excise duties as a share in GDP is close to the European average, while in total tax revenue it is almost 80% higher than the average in the countries of the EU. Excises are paid in Croatia by both producers and importers, and since 1 January 2002, the tax procedure has been carried out by the Customs Administration.

Excises that have been defined in common for EU countries have been introduced into Croatia; below we shall give a more detailed comparison of the European and the Croatian systems. This is at the same time about the most important excises in Croatia (on mineral oils, on tobacco products and alcohol beverages), by which almost 90% of all revenue from excises is collected.

Excise on tobbaco products

The Common Taxation of Tobacco Products Agreement which has been in force since 1993 determines the common tax structure in the member countries, the minimum rates and the harmonisation of procedures for the keeping and moving of taxable products. The taxable items are cigarettes, cigars and cigarillos, smoking tobacco, fine-cut tobacco for the rolling of cigarettes, and other smoking tobacco.

- Excise duty on cigarettes (Directive 92/79/EEC, 99/81/CE) is calculated according to a special method (per unit of product, or on 1,000 items) and by the proportional method (ad valorem, calculated on the basis of the maximum retail selling price). Taking into consideration both methods of calculation, a minimum rate of 57% of the retail price is prescribed (including other taxes, e.g., sales tax or VAT) for the most popular category of cigarette, later called the “57% rule”. For the sake of avoiding the effect of inflation during the ad valorem calculation, the rate is set every 1 January according to the statistical data about the rise in retail prices.

- Excises on other tobacco products (Directives 92/80/EEC, 99/81/CE) are calculated either as a percentage of the retail price or per unit, or per kilogram.
- Member countries can choose the proportional method or the special method of calculation alone, or a combination of the two methods.
- Since the minimum rates have been set, individual countries can introduce excises greater than the minimal, and there are considerable differences among them in the tax burden and in the prices of these products. These differences lead to cross-border shopping (legal and illegal) and also have an impact on doing business of the tobacco industry.

Croatian excises on tobacco products are harmonised with the EU with respect to kinds of products that are taxed. However, the amount of excise on cigarettes expressed as a percentage of the retail price for the standard group of cigarettes comes to 49.1%, so less than the prescribed minimum excise according to the "57% rule", although even inside the member countries there are countries (Austria 56.2% and Sweden 49.9%) which have rates that are lower than the set minimum rate. Excise on tobacco is considerably lower (5.2 euros/kg) than that prescribed in the EU (25 euros/kg), while for cigars and cigarillos it is higher, although it is hard to compare the figures since most countries calculate excise as a percentage of the retail price.

The taxation procedure is harmonised with EU procedures. Until delivery, the products are kept in bonded warehouses and after the payment of excise are marked with the control stamps, and are then delivered to the market. Products that are exported (with the existence of a formal export procedure) do not have excise levied on them because this will be calculated and charged in the importing country.

The problem of illegal sales, contraband in tobacco products and tax evasion that is a concern to EU countries exists in Croatia too, leading to the loss of a large part of budgetary revenue. It is estimated that cigarette smuggling leads to the loss of up to 400 million kuna being lost to the national Budget (Vecernji list, 7 June 2002). This is one of the reasons for the launch of the major international customs campaign for the prevention of cigarette smuggling called "Bulldog 2" on 15 June 2002, patronised by the South East European Cooperation Initiative (SECI). The campaign will be run by the Croatian customs administration and its headquarters is located in Bucharest.

Excise duties on alcohol and alcoholic beverages

Beers, wines and other alcoholic beverages are taxed with excise duty on alcoholic beverages (Directives 92/83/EEC, 92/84/EE), while the minimum rates, which are reconsidered and adjusted according to need every two years, are set within range from 0 to 1,000 euros per hectolitre.

In Croatia, excise duty on alcohol is calculated per litre of absolute alcohol in ethyl alcohol, distillates and alcoholic beverages at a temperature of 20°C and comes to 816 euros/hl, which fits in with the European average. Wine is taxed at a zero rate, as in most European countries that are important wine producers. The owners or users of agricultural land and the owners of the components for the production of alcohol or alcoholic beverages that produce drinks for their own consumption up to 20 litres of absolute alcohol a year per farm household do not have to pay the tax.

Excise on beer in the EU is set by the regulations for the taxation of alcoholic beverages. Standard and reduced rates have been introduced. Because of the differences in the concentration of alcohol and the concentration of extract in the malt of beer, within given countries there are a large number of rates, and the differences between countries are still greater. The brewing industry will have a considerable influence on the rate of tax and the rates in countries with substantial brewing industries (Ireland, Germany and Belgium) are much lower.

Excise on beer in Croatia (27 euros/hl) is higher than in most EU countries. Non-alcoholic beer is taxed in only four EU countries, and in Croatia the rate (8 euros/hl) is two and a half times as greater as the highest rate introduced elsewhere (Portugal, 2.96 euros/hl). Brewers who produce beer for their own consumption in Croatia, up to 15 hectolitres annually, do not pay the tax. In the EU a reduced rate is applied to small producers with an annual production of up to 200,000 hectolitres.

Excise duties on mineral oils

From 1993 harmonisation of the structure of excise on mineral oils has been under way, as has the definition of exemptions and reduced rates (Directives 92/81/EEC, 92/108/EEC, 94/74/EC). Products that are taxed are defined for all members by the Common Nomenclature. The tax base is 1,000 litres or kilograms of product at a

temperature of 15°C. The directive also defines the place of taxation and exemptions, and the procedure for applying rates and exemptions. A decision of the Council (95/510/EEC) approved deviations from the agreed on system for the implementation of exemptions and reduced rates within the member countries.

In the early phase of working out documents about the taxation of mineral oils the Commission, in line with the Internal Market programme, proposed an absolute harmonisation based on average rates because "in this area there is a much greater risk of competitive distortion of prices than for alcohol and tobacco products (1987h, COM (89) 525). Still, in 1992, minimum amounts of tax for leaded and unleaded petrol, diesel fuel, gas oil, liquid petroleum gas and kerosene were set, in a range of from 0 to 227 euros per litre or kilo.

In 1997 the Council passed a new Energy Products Directive (COM/97/30), which the European Parliament adopted in 1999 (A4-0171/1999). The basic intention of this Directive was that the taxation of all energy products (including the taxation of electricity) should lead to the implementation of the EU ecological policy, which emphasised the need to stabilise the emission of gases (CO_2, methane). Thus tax policy became an important instrument in the implementation of:

- energy policy (balance in the use of various sources of energy),
- environmental protection policy (differences in the taxation of leaded and unleaded petrol),
- transport policies (differential taxation of transport),
- agricultural policy (specially reduced rates for fuel obtained from agricultural, bio-fuels),
- employment policy (increase of tax revenues from the use of raw materials and energy, and reduction of the tax burden on labour).

Although a minimum excise duty was set, member countries were allowed to introduce complete or partial exemptions, or to introduce preferential taxation for given products. Particularly important is the autonomy of each country freely to determine exemptions for renewable sources of power, bio-fuels, ecologically more acceptable fuels, natural gas and so on. Council decision 2001/224/EC adopted the introduction of reduced rates and exemptions for some mineral oils for special purposes in all member countries for a six-year period (up to 31 December 2006).

It is still in the area of the taxation of mineral oils that there is the least degree of harmonisation, and this cannot be expected to be settled in the very near future.

Excises on mineral oils are lower in Croatia than in the countries of the EU. A considerable difference exists in the taxation of diesel fuel, the excise on which in Croatia (136 euros/hl) is almost half as much as the minimum excise in the EU (245 euros/hl), which is applied in France, and almost six times as little as the maximum (839 euros/hl), which is applied in the UK. In line with the directives the tax burden on leaded fuel is greater, as is a certain relief relating to the use of specially marked diesel fuel in agriculture and fisheries. This is the same with the lower price for heating gas oil. The greatest difference is in the taxation of kerosene and kerosene used as propellant which is taxed at the zero rate in Croatia, while in the EU there is a minimum rate of 245 euros for 1,000 litres. Products that are taxed are kept in bonded warehouses reported to the Customs Administration. If the products are exported, excise is not paid, rather the products are taxed in the importing country.

Excise duties in Croatia versus EU requirements

In line with EU requirements:

- products that are defined in common in EU countries (tobacco products, alcoholic beverages and beer, mineral oils) are taxed;
- supervision and collection are carried out by the Customs Administration;
- there are registered and controlled bonded warehouses from which products are delivered to the market;
- products that are exported are not taxed rather this is done in the importing country;
- for given taxes ecological, health and economic requirements are taken into consideration.

Deviation from EU requirements:

- as in most countries which are in the procedure for joining the EU, the rates are lower than they are in the EU, except for beer;
- the categorisation of products (alcohol and mineral oils) is not fully harmonised.

CONCLUSION

In this work we have given the results of comparisons and analyses made and made suggestions to the creators of tax policy in Croatia to do with the further harmonisation of the Croatian tax system with European requirements.

The basic objective of the tax policy of the EU is to support the constant development of the EU internal market. This objective is achieved by the accomplishment of sub-objectives: the removal of tax barriers for the realisation of the four freedoms and by measures that contribute to a lasting reduction of the total tax burden.

The key device for achieving the aims stated is the harmonisation of the tax systems of the member countries. The basic legal instrument prescribing tax policy at the European level is the directive. In the member countries, a number of legislative and other measures have been undertaken so that, according to the solutions of the standardised directives, taxation via direct or indirect taxes should be harmonised.

So far two directives from the area of profit tax, known by the abbreviated titles of the Parent-Subsidiary Directive and the Merger Directive have been accepted. The objective of the Parent-Subsidiary Directive is to do away with the possibility of double taxation of dividends that are paid to the parent firm in another member country. It is not advisable for Croatia to build the standards of this Directive into its legislation until the status of EU member has been achieved, for in this way Croatia would give up the taxation of dividends, rather tax would be paid on this dividend in the country from which the foreign investor in a Croatian corporation comes. The case with the Merger Directive is similar, and the recommendation for Croatia is the same. If it were to be adopted in the Croatian tax system, the takeover of Croatian corporations by foreign firms would be made easier without there being any reciprocity from the European side.

With reference to the harmonisation of legislation relating to value added tax, it is the Sixth Directive that is the most important. This regulates all the essential elements of the taxation of added value. Croatia too has built value added tax, founded on the approaches of the Sixth Directive, into its tax system. Still, there are certain inconsistencies, the most important being the discriminatory provision about the institutionally regulated tax exemptions for the services of banks and insurance companies. In this segment, then, it would be necessary to

harmonis the approaches of the Croatian legislation with the provisions of the Sixth Directive.

In the EU excises are regulated by a large number of directives. The regulations that relates in Croatia to excise is mostly harmonised with the requirements of the EU. An exception is to be found in the tax rates, which are lower than the minimum EU tax rates. The lack of harmonisation of the rates of excise duties, however, is a serious problem within the Union itself, because the Member States apply difference excise rates for the same products. Croatia has established a system of taxation via excises that in its conception is equivalent to the European and that will, when this is necessary for the sake of being accepted into the EU, be fairly easy to adapt to European standards.

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[i] *For more information see OECD (2002) and IBFD (2000).*

[ii] *For more about tax trends in the OECD and in the EU, see: Ott, K. [et al.] (2001), Messere (1998).*

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Chapter 5

STATE AID IN THE EUROPEAN UNION AND CROATIA

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Bad government, like bad luck, kills off growth.
William Easterly, 2002, p. 217

ABSTRACT

EU policy on the state aid granted by member countries to their national economies is based on a general presumption that state aid is incompatible with the running of the single market. The European Commission has the right to ban any state aid that distorts market competition by extending privileges to certain firms and sectors (or by favouring certain firms and sectors. The EU instruction is that national state aid should be reduced and that it be reoriented towards horizontal objectives, for only then are they assisting all firms and sectors alike. In the Republic of Croatia government expenditure to promote the economy is considerable and mainly directed towards certain sectors: shipbuilding, tourism, transport and agriculture. It is to be expected that in order to comply with EU policy Croatia will have both to reduce the extent of state aid and redirect it towards horizontal objectives.

Key words:
EU, Croatia, state aid

INTRODUCTION

The purpose of this paper is to show what Croatia should do in order to draw closer to the EU in its state aid policy. The remainder of the paper is organized as follows. In the next section, the policy of the EU in the area of state aid is laid out; section three gives a survey of state aid in Croatia, while the fourth section sums up by stating the current situation of state aid in Croatia and what needs to be done to approach the position of the EU. It should be noted that the paper is but an initial attempt to draw up a review of state aid in Croatia as there are almost no papers that discuss this matter. Research has been hampered by the lack of published information about the kinds, recipients and amounts of state aid. Precisely because the lack of proper figures, in this phase of the research it was very difficult in a short period to give a reliable quantification of the amount of total state aid in Croatia. That is why we provide only a review of state aid according to the agencies in charge of granting it, in an attempt to delineate the sectoral distribution. Increased transparency in the monitoring of state aid urged by the EU in all of the candidate countries will certainly facilitate easier calculation of the extent of total state aid. Transparency of the state aid system will facilitate monitoring and sectoral analysis, and will free government policy concerning state aid from lobbyist pressures.

ANALYSIS OF THE ACCESSION CONDITIONS FOR THE NEW EU MEMBERS

State aid - reasons for and against

State aid is a form of state intervention[i], the aim of which is to encourage some economic activity, sector or firm. It distorts competition, because it discriminates between those who receive aid and those who do not (Commission of the European Commission, 2002). What does distortion of competition mean? The market criterion in the judgement of whether some aid distorts the competition is: competition is dis-

torted if no participant in the market wishes to invest the same amount under the same conditions in a firm that the state supports (Lavadas and Mendrinou, 1999). That is, the state, through its aid, redirects the flow of investment into industrial activities and firms that private investors do not invest in (Adams and Klein, 1985; Schultze, 1986; Krugman, 1986).

Traditional state intervention is commonly focussed on to the state selecting those industrial activities or firms that are considered to need assistance. These are either the future "winners", that is, those activities and firms expected to attain high rates of growth, or loss-making undertakings and firms which use state aid for survival and rehabilitation. This kind of state intervention is premised upon government possessing the analytical capacity to determine, better than the market, the appropriate economic structure, to select the sectors and firms that are potential winners, determine which loss-makers should be rescued, and determine the measures through which this should be carried out.

But experience has demonstrated that this kind of traditional approach is inefficient and does not lead to restructuring and growth. The government has proven itself incapable in many ways. It has not known how to pick a winning sector, it has not known when to stop assistance, i.e., when a certain activity is capable of operating on its own, and with its frequently wrongly chosen measures has brought many distortions into the economy thus reducing economic efficiency. Under pressure from various lobbies the network of state intervention has become increasingly complex, and the state administration ever more corruptible. When some intervention has become settled, there is a risk that the government will become influenced by interest groups who lobby, successfully, to keep the aid, although this is no longer economically justified.[ii] Apart from that, there are always new candidates who would find state aid quite handy. For why should agriculture be subsidised and not tourism nor the food industry, which are linked with agriculture? Under the pressure of interest groups, state aid is hard to remove, new aid is granted, and the vicious circle is hard to break.

In addition, state intervention leads to unfair competition between subsidised and non-subsidised firms. The lower prices that can be charged by subsidised firms, and which are not the result of increased quality or productivity, lead to well-performing but nonsubsidised firms but having to charge higher product prices being squeezed out of the market. At the same time a growing state aid creates an increasing pressure on the government budget, which in turn results in higher taxes and undermines the fiscal sustainability. Ultimately state aid has to be financed out of taxes, and for this reason,

all taxpayers bear the cost of them. Although they face lower prices for subsidised goods, consumers ultimately, through increased tax rates, nevertheless pay the full price of such goods.

Although because of the many negative consequences of aid the state should be very circumspect with its policy, it is also true that state aid sometimes can stimulate growth. Thus the EU is not an opponent of state aid, but thinks it should be directed only into areas where market does not perform, i.e., where there are examples of market failure (Commission of the European Community, 2000). The emphasis is placed on the complementarity of government and market, and it is considered that markets supported by the state are needed to attain successful economic growth. Table 1 gives examples of market failures, and the manner in which they can be palliated by aid.

Table 1. Market failures

Name of market failure	Example of market failure	Most common form of state aid
Public goods	Lightouses, street lighting, public radio and television	Direct provision of the service by the state
Merit good	Programs for vaccination, cultural services and-elementary education	Subsidising or total financing
Economies of scale	Monopoly or oligopoly markets	Aid to firms entering the market
Externalities, positive and negative	Research and developement; pollution	Subsidising; taxation regulation
Incomplete, imperfect or asymmetric informations	SMEs find it hard to obtain finance	Subsidised interest, guarantees, information centres
Rigidity of the labour market	Minimal wage	Reduction of contribution, subsidised wage
Reduced mobility of factors	Work and capital move with difficulty into undeveloped	Improving the quality of infrastructure regions
Difficult adjustements to market subsidizing	Firm or sector that needs to be restructured	Help in exiting he market
Foreign subsidising	Assistance to domestic industry to protect it from-the effects of subsidies granted by other countries	Subsidies, negotiations in the WTO

Source: European Commission, 1999; 25

But for the use of state aid to be justified, it is not enough to determine the existence of a market failure. It is also necessary to give reasoned proof that the public sector can solve the particular problem better than the private sector (Sandmo, 2002). Also very important is the proper selection of the form of state aid. For all possible forms of state aid, such as subsidies, tax exemptions, soft loans and others have their advantages and drawbacks, and can have very different impacts on the economic efficiency of a given sector, the economy as a whole, and the welfare of the citizens. Before applying a given form of state aid, it is necessary to compare all the benefits and costs (direct and indirect) that it entails.

EU policy with respect to state aid[iii]

Of the numerous regional groupings, only the EU in an explicit manner determines the control of the state aid of its members (European Commission, 1999). State aid undermines the principle of unbiased and free competition, and amounts to a limitation of the functioning and development of the single EU market. For this reason the European Community Treaty set up a system of rules allowing members to use state aid only in exceptional cases.

Article 87(1) of the EC Treaty basically says that state aid and the single market *are not* compatible because state aid granted to a firm or an activity affects trade among the member states. More precisely, this article states that "all aid that is given by member state in any form that distorts competition because by its partiality it gives an advantage to given firms or products and thus has an effect on the flows of trade among the members is not compatible with the single market." If the regulations of the countries were really to be based only on this one article, then the member countries of the EU would not have much room for intervention to support given regions or national economies. However Articles 87(2) and (3) solve this problem, clearly stating which aid measures may be permitted if they do not adversely affect the common market. From the length of the schedule of such state measures it is clear that a wide space is left for aid at the level of individual countries and the whole of the EU. Aid that is allowed in Article 87(2) relates to aid of a social character, on condition that it does not result in discrimination of products with respect to a national or regional origin; aid that makes

good damage caused by natural disasters or other unpredictable events and aid meant for those regions of Germany that were hit by the division of the country. Article 87(3) expands the space for intervention even further by listing aid that can be considered compatible with the common market, for example aid that promotes the economic development of areas in which the standard of living is atypically low or in which unemployment is very high; aid that makes possible the conclusion of projects that are of common European interest or those that mitigate serious distortions in a national or regional economy; aid that makes possible the development of certain economic activities or areas and that does not have a deleterious effect on commerce among the member countries; aid that promotes the conservation of the cultural heritage and the environment, and all other kinds of aid that the Council of Europe can vote in with a qualified majority.

Considering the number and heterogeneity of the kinds of aid allowed it is clear that the basic motivation for the control of state aid at the EU level is not that it should be done away with or banned rather that unnecessary distortion of market competition within the EU be diminished. This is achieved by monitoring and regulating aid and defining and adjusting the conditions in which member states can provide specific structural and/or regional aid. Article 88 gives the duty and right to control state aid to the European Commission. For this reason, member states must inform the European Commission about national aid policies, and the Commission's remit is to determine whether they are compatible with the objectives of the European Community Agreement. Of course, the Commission cannot control every kind of instrument that national members can apply and that affect or might affect corporate behaviour. Control relates only to those measures that meet all the criteria stated in Article 87(1)[iv], i.e., that a given measure of aid:

- means a transfer of state resources,
- results in an economic advantage that the firm or product would otherwise not have,
- implies selectivity, which means that the application of the measure changes the relationship among firms or products,
- has an effect on the competition and trade between the member countries. Aid is bound to modify the degree of competitiveness.

Accordingly, the general criterion of a permissible measure is that it is in line with the obligations of the Agreement and that it is limited to the smallest possible measure necessary to achieve the aims of the intervention. This actually means that the objective of every sectoral aid, to be acceptable, must be the attainment of the long-term sustainability of the sector (which is achieved by settling structural problems or reducing capacity). If the aid that some state gives does not meet these criteria, the European Commission has the *duty and the right to forbid* such aid.

These measures became the subject of an active policy of reducing state aid. Thus at meetings of the European Council in Stockholm in 2001 and in Barcelona in 2002, member states were required to reduce state aid (defined in Article 87(1)) as proportion of GDP and to redirect state aid to the support of horizontal objectives.[v] Horizontal objectives prevent the possibility of regional or sectoral favouritism and are concentrated on the removal of market failure and can be considered to distort competition less. Typical horizontal aid is directed to research and development, environmental protection, the development of SMEs, commerce, energy saving, restructuring of firms, employment, sustained training and so on. The most recent report of the European Commission about trends in aid in the EU (European Commission, 2002) shows that the members on the whole are adhering to the Stockholm and Barcelona instructions, but that there are still great disparities among them (Table 2).

An aid category that is very often used is what is called *ad hoc* aid. All aid not foreseen by the existing instruments has an *ad hoc* character. Such aids are usually used for restructuring and bailing out firms. They are characterised by the principle of minimal amounts and the principle of non-recurrence, i.e., they are given only once and never again. Most of this kind of aid goes to industry, particularly to the shipbuilding and steel sectors (more than 50%), but a considerable number of such aids are directed towards financial services and air transport.

From this table it can be seen that in the EU state aid came on average to 0.99%[vi] of GDP in 2000, and that it fell during the 1996-2000 period. At the same time the proportion of horizontal aid rose, and in 2000 it came to 47% of total aid.

Most aid goes on transportation, mining, agriculture and fisheries, and within the help to manufacturing industry, on shipbuilding and steel production. The most frequent form in which aid was given to industry and services was the subsidy (EU average 63%) and tax

exemptions (EU average 25%). However, there are considerable differences in the member countries; for instance, Luxembourg, Finland and the UK give their support to manufacturing industry and services mainly via subsidies (95.91 or 96%), while Ireland uses these much less often (only 19%), making much more use, however, of tax exemptions (74%).

Table 2. Basic data concerning trends in state aid in EU member states

	State aid as % of GDP (2000)	Trends in aid as % of GDP (1996-2001)[1]	Horizontal as % of overall aid (2000)[2]	Trends in the proportion of horizontal aid as % of overall aid [1,2]
EU	0.99	-0.25	47	12.2
Belgium	1.34	-0.11	77	3.0
Denmark	1.23	+0.15	83	0.7
Germany	1.23	-0.26	46	14.4
Greece	0.89	-0.40	8	4.4
Spain	0.99	-0.20	42	7.4
Finland	1.44	-0.30	71	1.3
France	1.13	-0.24	42	9.1
Ireland	1.20	+0.34	55	12.9
Italy	0.92	-0.47	33	11.8
Luxembourg	1.24	+0.18	47	9.9
Netherlands	0.98	+0.09	75	2.6
Austria	0.97	-0.18	58	-1.5
Portugal	1.18	-0.44	38	7.4
Sweden	0.75	-0.11	61	3.0
UK	0.46	-0.17	60	4.1

[1] Change of percentage between annual average for the period 1996-1998 and 1998-2000
[2] Total aid reduced by that for agriculture, fisheries and transportation.

Source: Commission of the EC, 2002

ANALYSIS OF STATE AID IN CROATIA

EU and state aid in Croatia

Through signing the Stabilisation and Association Agreement (SAA) Croatia, among the many obligations, took on obligations about state aid. Thus Article 70 of the SAA stated that Croatia had to set up an independent operational body for the monitoring and implementation of state aid. The work of this body would be to draw attention to every item of state aid that would distort market competition by favouring some firms or products. This body will approve programmes of state aid and order the return of aid given illegally. It should also draw up a comprehensive list of all aid programmes, and bring these programmes into compliance with EU criteria in a period of at the most four years from the time the SAA comes into force. There should be a legal base for such activities in a state aid law. According to the plan of the implementation of the SAA, the work of adopting this law, the foundation of the body charged with state aid matters and the drawing up of the list of existing state aid should be done during 2001 and 2002. The objective of the EU demands made on Croatia is to increase the transparency of the system of state aid and to see that state aid is funnelled in line with the aims agreed on among the member states of the EU.

A review of state aid in Croatia

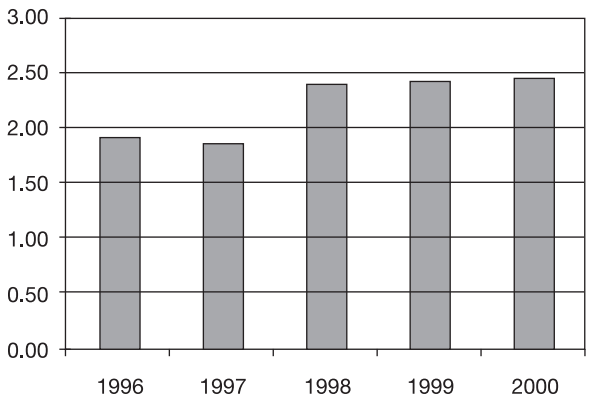
This chapter will endeavour to give a brief overview of state aid in Croatia. This is only a survey of a very complex phenomenon, and not any kind of quantification of the total amount of state aid. For information about state aid is not yet kept in any single place, and has to be assembled from numerous sources, from Official Gazette, the papers, the Web pages of individual ministries, or be obtained from personal sources. This makes it more difficult to provide in-depth analysis or evaluation of it. We hope that when the actions relating to state aid that the EU has imposed as an obligation on Croatia are carried out this problem will be solved, and that the review of such aid will be more transparent.

The review of state aid has been done according to those in charge of it; there are direct subsidies from the national Budget,

favourable loans and guarantees that are given via the Croatian Bank for Reconstruction and Development (known as HBOR), the Ministry for Trades and SMEs (MOMSP) and the Croatian Guarantee Agency (HGA); subsidised employment via the Croatian Employment Service (HZZ/CES) and tax incentives that are given pursuant to the tax laws. We have also put available information about corporate rehabilitation into the review, which is also a considerable form of state aid in Croatia.

Apart from these state aids, which have been being allocated for quite some time, certain statutory approaches for the stimulation of the economy have been passed that have not yet come fully into force. Thus in July 2000 the Investment Incentives Law was passed, the aim of which, via various measures (subsidies, tax and customs incentives and so on) was to stimulate the development of the economy. During 2001, the following regional funds were set up: the Development and Employment Fund and the Regional Development Fund, the aim of which is also to encourage the development of the economy. The newly founded Croatian Small Business Agency will also deal with the stimulation of development, while support to Croatian exporters and domestic and foreign investors will be supplied by the Promotion of Export and Investment Agency set up in September 2002.

Figure 1. Direct subsidies as % of GDP



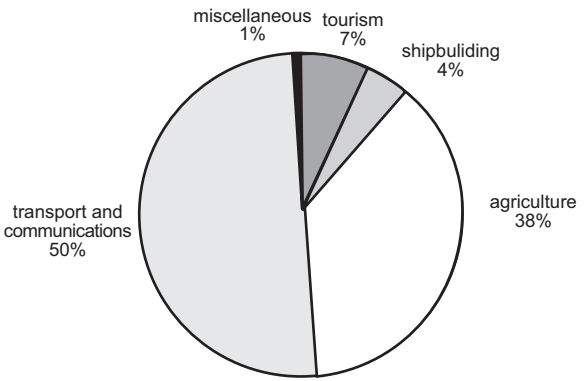
Source: MF Republic of Croatia, 2000 and internal data of Ministry of Finance

Direct subsidies from the national Budget

In 2000, 3.8 billion kuna in current subsidies were allocated from the national Budget, coming to 2.4% of GDP (Ministry of Finance, 2001). Subsidies recorded a jump in 1998, when they grew from 1.86% GDP to 2.38%. In the period after 1998, they mainly remained at the level of about 2.4% of GDP (Fig. 1).

It should be emphasised that subsidies are also allotted at a local level as well, and not only from the national Budget. Thus in 1999, at the level of general consolidated government, subsidies worth 3.9 billion kuna were given, but from the national Budget 3.4 billion kuna (Ministry of Finance, 2001). The difference between the two sums is made up of subsidies granted at lower levels of government. Thus in 1999 about 500 million kuna worth of local subsidies were allotted, i.e., about 13% of national level subsidies.

Figure 2. Direct subsidies as % of GDP



Source: MF Republic of Croatia, 2001 and internal data of Ministry of Finance

In 2000, state subsidies were mainly allocated to transport and communications (50% of overall subsidies), agriculture (38%), tourism (7%) and shipbuilding (4%) (Fig. 2). There are no great differences here between Croatia and the EU average. The biggest single beneficiaries are Croatian Railways, subsidised to the tune of 1,276 million kuna, agriculture with 1,233 million kuna, Jadrolinija Rijeka with 166 million kuna, BINA Istria[vii] with 288 million kuna, and firms in the tourist industry with 266 million kuna.

Favourable loans and guarantees of HBOR, HGA and the Ministry of Trades and SMEs (MOMSP)

Croatian Bank for Reconstruction and Development (HBOR)

The fundamental activity of HBOR comprises programmes of loans to firms and programmes of providing guarantees. With these programmes, HBOR takes part in the reconstruction and development of the economy and the infrastructure, incentives to SMEs and financing and giving security for the export operations of the Croatian economy.

According to HBOR's Annual Report for 2000, 1.6 billion kuna were spent on loan programmes, and 2.5 billion kuna for guarantees, i.e., a total of 4.1 billion kuna. About 90% of the total activity of HBOR was accounted for by sectoral aid, and about 10% by horizontal measures, this mainly for incentives to small and medium sized enterprises.[viii]

The interest charged on loans made available by HBOR via the commercial banks are lower than the market rates for the end users. Via its Interest Rate Decision, made by the Supervisory Board, HBOR sets the interest rates for its loan programmes. On 26 February 2002 the Supervisory Board of HBOR made an Interest Rate Decision according to which the rates for end users ranged from 3% a year (for users with direct war damage) to 7.5% for all other users. At the same time the average interest rates of the commercial banks, for long term kuna denominated loans to the corporate sector without a foreign currency clause were 8.69% p.a. (Croatian National Bank, 2002). Thus the interest rates for HBOR loans are much lower than the interest rates on the money market. Via HBOR, then, the state allocates more favourable loans and gives incentives for the development of business, mainly tourism and shipbuilding, and partially the development of SMEs.

Croatian Guarantee Agency (HGA)

A relatively small guarantee business is done via the HGA, which provides support for the development of enterprise. Aid relates to small and medium size firms, sole traders, tradesmen, co-operatives, individual farmers and freelance operators. According to the HGA Annual Report (HGA, 2001), in 2000, 604 guarantees for loans amounting to 115 million kuna were made, and 3.9 million kuna worth of

non-returnable aid was given. Most guarantees were made according to the Programme for Areas of Special Concern of the Republic of Croatia, that is, mainly for the regional development of SMEs.

Ministry for Trades and SMEs

The Ministry for Trades and SMEs (MOMSP) mainly hands out loans to existing small enterprises or beginners, and for the development of new technologies, export and tourism, and for restructuring. Loans from the MOMSP programme are also approved and implemented via the commercial banks and local self-government units. During 2001, 2,264 loans were made, to a total amount of 1.1 billion kuna, which is twice the amount loaned in 2000. In 2001, the loans were made with an interest rate that ranged from 5.5 to 7.5% (Jutarnji list, 2002). Thus, like loans from HBOR, loans from MOMSP are a very favourable way for businesses to borrow money, and the difference between the subsidised interest and market interest rates is a direct subsidy to the user of the loan.

Employment incentive

During 2002, the government adopted a Programme for Employment Incentives (NN 21/2002), which contains six sub-programmes:

- A - *From University to Job* – for persons with a degree younger than 27 who took their degree within the average time for the institution.
- B - *From Classroom to Workshop* – for skilled and highly skilled workers without work experience who are completing secondary vocational schools.
- C - *By Studying to Work for All* – oriented to education for specific labour market requirements.
- D - *By Experience to Profit* – for older persons with experience.
- E - *Opportunities for Us Too* – the employment of disable persons and persons who are hard to employ.
- F - *Jobs for the Defenders* – hiring Croatian veterans and their wives and children if they are unemployed.

The institution in charge of these programmes is the CES. A programme is carried out via the joint financing of hiring, the CES subsidising for the employers some of the costs for the newly employed and thus making labour cheaper. It is expected that during 2002, 14,029 people will be employed via these programmes, and that 179 million kuna will be spent (DZS, internal figures).

Tax incentives

The Profit Tax Law (NN 127/2000) allows taxation incentives that have the form of indirect state aid to firms.

Incentives to regional development

Taxpayers who carry out some activity in an area of special national concern pay profit tax at a rate that might be 25, 50 or 75% of the prescribed rate of profit tax, i.e., 20%. In these areas, then, profit tax comes to 5, 10 or 15%. Taxpayers in the area of the city of Vukovar are totally exempted from the payment of profit tax for a period of five years from the start of their activity, and after that have to pay profit tax at 25% of the prescribed rate.

Incentives in free zones

Free zone users pay profit tax at a rate of 50% of the prescribed rate. If a zone user invests 1,000,000 kuna in the free zone, in the next five years it will not pay profit tax at all. If the free zone is in the area of the Vukovar and Srijem County, it will not pay tax for five years from start-up, and then will pay profit tax at 25% of the prescribed rate.

Investment incentives

Privileged profit tax rates depend on the amount of the investment and the number of employees in the firm. The opportunities for taking advantage of privileged rates, which only new firms can have, are given in Table 3.

Table 3. Tax privileges for investments

Amount of investement	Preferential rate	Period of use of the preferential rate	Employment obligation
At least 10 milllion kuna	7%	10 years from the beginning of the investment	At least 30 employees
More than 20 million kuna	3%	10 years from the beginning of the investment	At least 50 employees
More than 60 milllion kuna	0%	10 years from the beginning of the investment	At least 75 employees

Employment incentives

The tax base can additionally be reduced by the amount of pay and employer's contributions for new employees during the first year from their hiring. In this manner, these wages can be deducted twice: first as an expenditure while the profit is being calculated, and the second time as a reduction of the then determined base for profit tax.

Uncollected taxes

Uncollected taxes are usually considered an indirect subsidy. Tax that is not collected and is written off by the government or is collected in a reduced amount after a settlement is made with the taxpayer constitutes indirect financial aid to the tax defaulter. Apart from this, such measures distort competition, because it puts regular taxpayers into an unequal position as against the taxpayer whose debt is excused. Croatia has a law in force called the Collection of Due but Unpaid Taxes, Customs Duties, Contributions and Government [State] Guarantees Law (NN 117/2001 and NN 95/2002). Taxpayers whose debt was incurred up to 31 December 2000 have the right to come to a settlement with the government, and pay their debts in one of these ways: a one-time payment with a reduction, transferring claims, ceding real estate, rescheduling claims and ceding claims or multilateral compensation. The total claims with respect to uncollected debts to the state come to more than 21 billion kuna. Within the time limit allowed

by the law, that is, until 23 January 2002, more than 35,000 debtors (firms and tradesmen) reported a total of 5.33 billion kuna, or about a quarter of the total debt to the state (Poslovni tjednik, 2002a). This tax debt could be met by the debtors by a settlement with the state via one of the models anticipated. Thus the state will collect part of the debt, and the rest will become an indirect subsidy to these tax defaulters. The remainder of the debt will probably never be collected, and in its full amount can be considered an indirect state subsidy.

Corporate rehabilitation

Company bailouts are usually done by cancellation of debts or by the transformation of them into equity. The EU classifies debt conversion too as one of the forms of state aid because without such aid, loss-making firms would not be able to survive on the market. In the Republic of Croatia too such a form of help to loss-making firms is frequently used, and the government has often made decisions attempting to rehabilitate firms it owns. This has primarily concerned shipbuilding and the agribusiness firms. Thus in February 2001 the government adopted its Provisional Measure for the consolidation of companies in agriculture in which the government authorised the line ministries to write off their claims, to reschedule them or turn them into equity. According to government estimates, the debts of the big agricultural companies came to about 2.2 billion kuna (Jutarnji list, 2001).

In addition, after 1997, when the government of Croatia had adopted its Decision to bail out certain companies (NN, 118/97), a rescue process was started up in five shipyards. Through this decision, creditors were supposed to swap their undisputed due claims for shares, or equity in firms owned by the Croatian Privatisation Fund, or the Republic of Croatia. Since the government was dissatisfied with the modest results of the rescue operation carried out, in August 2002 it adopted financial measures to help the shipbuilding industry that came to a total of 2.8 billion kuna. These measures related to taking over the repayment of loans to the national Budget and the write-off of debts to the Ministry of Finance relating to payments made for guarantees issued. The programme of these financial measures relates to the period up to 2008. The government also obligated itself to subsidise the building of ships in the amount of 10% of the sale price of a ship (Vlada RH, 2002).

Investment Incentives Law

In July 2002, the Investment Incentives Law was passed (NN, 73/2000), allowing a number of incentive measures to be carried out: the leasing of real estate owned by the Republic of Croatia, assistance in job creation, assistance in training and further training, tax breaks[ix] and customs privileges (non-payment of customs duties for the import of equipment). These incentives are available only to new firms for investments that come to at least 4 million kuna, domestic firms having priorities in obtaining such privileges. During the two years of the implementation of the law, only 9 firms obtained the right to these incentives, in the amount of 803 million kuna (of which, 646 million kuna relates to the firm Metro Cash & Carry) (Poslovni tjednik, 2002b). But in 2002, an amendment to the law was prepared, and it was in the parliamentary procedure during the autumn.

Development incentives via the development funds

At the end of 2001 laws were passed to found two development funds: the Development and Employment Fund and the Regional Development Fund of the Republic of Croatia (NN, 107/2001). The funds are mainly financed from the Budget, and with revenue from privatisation; they can also borrow short-term up to at most 25% of the annual financial plan, and, pursuant to a government decision, even more than that if resources from privatisation have not accrued. Their basic objective is to encourage development and employment. However, these funds cannot be said to have started working properly yet.

The Regional Development Fund

The work of this fund is to encourage the development of war-torn areas, areas of sparse population, areas of special national concern, the islands, the hilly and mountain areas, border areas, areas with structural problems, areas that have a GDP lower than 65% of the national average, and other areas. The resources of the Fund in these areas are meant for the implementation of infrastruc-

ture and economic projects. The projects are chosen according to competitive bidding announced by the Fund, with counties and their projects taking part. A prior selection is carried out by a county for its own region, based on cost-benefit analyses for infrastructure projects, and on certain other criteria for business projects; profitability, export orientation, environmental impact, being based on domestic resources, and employment of the local population. The final choice of projects is made by the Fund's Board of Management. The selected projects are financed with loans the conditions of which the Board also sets, but which have to be more favourable than those on the money market. According to the Fund's Financial Plan for 2002, it is expected that 611 million kuna will be invested in regional development (NN, 26/2002).

Development and Employment Fund

The work of this fund is directed to the encouragement of trades, SMEs, to providing support during hiring, the encouragement of new technologies and export programmes, support for county programmes, help in the foundation of business and development centres, free and industrial zones, giving state-owned real estate for development purposes and for the reconstruction of facilities demolished in the war. After the announcement of invitations for bidding by the Fund, the choice of projects is carried out by the counties, which then recommend them to the Board of the Fund, which finally takes them on. The projects are financed with loans not worse than those on the capital market, by subsidising interest rates, purchase of bonds, assignment of real estate and equipment that the Republic of Croatia has at its disposal and with non-refundable aid. Projects that create new jobs, that are viable on the market, export-oriented, that use domestic resources and that meet environment protection regulations will have the priority in the allotment of resources. The Financial Plan of the Fund for 2002 envisages development incentive resources to the tune of 3 billion kuna (NN, 26/2002).

Croatian Small Business Agency and the Promotion of Export and Investment Agency

During 2002, two agencies were founded that have not fully started working as yet. Thus the Incentives for the Development of Small Business Law (NN, 29/2002) founded the Croatian Small Business Agency, the Managing Board of which was appointed in September 2002 (NN, 103/2002). The objective of the Agency is to provide incentives for the development of small business by a series of measures, from favourable loans, guarantees, aid to increase employment, and the provision of information to entrepreneurs. Resources for the work of the Agency are provided from the Budget, domestic and foreign funds and the banks.

In September 2002 the Promotion of Export and Investment Agency was founded (NN, 102/2002), the business of which is mainly to supply information support to Croatian exporters and to local and foreign investors; this should start coming on-stream by the end of 2002.

The definition of areas in which adjustments to EU conditions are required

Although the Croatian government has taken seriously the preparations for Croatia's association with and joining the EU, in the area of state aid there is still a lot of work to do. This relates to bringing the legal and institutional base into compliance, and also to an analysis of economic arguments in line with European understandings of the role of state aid. It is not in question that Croatia will have to change its way of thinking about state intervention. In the past the state made decisions about this independently. With EU entry, the final word about most such interventions will go to the European Commission. And although the Commission is very easy-going in giving its acceptance of aid in some member country, the fact is that on paper at least, the policy is based on the assumption that state aid distorts market competition and reduces efficiency. For this reason no single member can make autonomous decisions about the majority of the rules and instruments for giving aid. This, then, means that Croatia will have to adjust its objectives according to which aim is given to prod-

ucts, producers and regions. The hardest task will certainly to be to redirect state aid away from individual economic sectors and to horizontal targets.

In the area of the instruments that are used to implement aid there will also have to be adjustments, although not as drastic as those in relation to the actual targets. The introduction of differing tax regimes to attract new investors or restructure the economy will increasingly be considered an unacceptable form of state aid, and member countries are advised against the use of differential rates of taxation.

CONCLUSIONS AND RECOMMENDATIONS

State aid works against the principle of unbiased and free competition, and means a restriction in the functioning and development of the single EU market. For this reason the EC Agreement set up a system of rules according to which member states are allowed to give state aid only in exceptional circumstances. State aid that distorts market competition can be vetoed by the European Commission. The general EU recommendation is that member states reduce the extent of state aid up to 2003, and after that direct it to horizontal targets. This EU preference with respect to state aid will in the future very largely determine Croatian policy too with respect to state aid.

In order to be able to evaluate more easily the situation of state aid in Croatia with respect to EU demands, we tried above to systematise state aid according to the kind of division applied in the EU. All aids that are used in Croatia, then, have been classified into three groups: sectoral, horizontal and regional. It should be said that the amounts in Table 4 cannot be aggregated in order to obtain the total amount of all forms of state aid (subsidies, favourable loans, guarantees, tax breaks and so on). there are four reasons for this. Firstly, we do not have enough of the required information to calculate the amount of state aid for each measure. For example, the amount of loans given by HBOR to shipbuilding cannot entirely be considered state aid. State aid is only the difference between the HBOR rate and the market interest rate[x]. Secondly, the division of state aid into three groups means there is some overlapping: some of the measures are found into two groups. Thus HBOR loans for SMEs are included one time in horizontal measures, and a second time in regional measures, where they refer to loans to SMEs in areas of special national concern or on the islands.

Table 4. Sectoral, horizontal and regional state aid in the Republic of Croatia

	Measure	Source/in charge	Amount (mil kuna)	Year
Sectoral aid				
tourism	subsidies	national Budget	266	2000
	favourable loans	HBOR	359	2000
shipbuilding	subsidies	national Budget	163	2000
	favourable loans	HBOR	697	2000
	guarantees	HBOR	2,503	2000
	rescue operation	government programme	2,800	2002
transport and communications	subsidies	national Budget	1,907	2000
agriculture	subsidies	national Budget	1,433	2000
	rescue operation	government	2,200	2001
restructuring	subsidies	national Budget	30	2000
and so on	favourable loans	HBOR	12	2000
exports	favourable loans	HBOR	180	2000
new firms for investments larger than 10 million kuna	reduced profit tax rate	Profit tax law		
Tax payers	settlements about unpayed tax	Collection of due but not collected tax law	21,000	2000
Horizontal aid				
SMEs	favourable loans	HBOR	181	2000
	guarantees	HGA	115	2000
	subsidies	HGA	4	2000
	favourable loans	MOMSP	1,128	2001
infrastructure	subsidies	national Budget	0.3	2000
	favourable loans	HBOR	70	2000
enterprise improvements	subsidies	national Budget	2.4	2000
	favourable loans	HBOR	143	2000
employement incentives	subsidies reduction of profit tax for newly employed persons	Profit tax law	178	2002

Regional aid				
areas of special national concern, islands	favourable loans	HBOR	89	2000
areas of special national concern, Vukovar, free zones	reduction of profit tax	Profit tax law		

Source: as in the text

Thirdly, data relate to different years. Fourthly, the list of state aid is not complete – it does not include the work of the Development and Employment Fund, the Regional Development Fund, measures according to the Investment Incentives Law, the Croatian Small Business Agency and the Promotion of Export and Investment Agency, because at the present their total activity in providing business incentives is nugatory.

However, irrespective of the restrictions given in the table, it is clear that most state aid in the Republic of Croatia is directed to the development of individual sectors, mainly to tourism, shipbuilding, transportation and agriculture. In 2000, 3.8 billion kuna or 99% of total subsidies from the national Budget were directed to these purposes alone, as were 3.6 billion kuna in HBOR loans and guarantees, or 86% of this bank's total activities. Additional stimuli to individual firms and sectors can be expected from the more extensive future activities of the Development and Employment Fund and the Regional Development Fund, as well as the more thorough implementation of the Investment Incentives Law.

Relatively few state resources went for horizontal purposes. Most marked was the work of MOMSP, HBOR and HGA, which hand out loans and guarantees for the development of SMEs. MOMSP is the most active in this respect, via which 1.1 billion kuna went in 2001 for loans to SMEs, the major state activity within horizontal measures. SMEs are considered to find it hard to obtain loans, because the banks do not have adequate information on the basis of which to estimate their probable performance. At the same time, SMEs find it more difficult to access information about new technologies and markets. For this reason state aid in correcting this market failure is considered a justified horizontal measure. During 2002, considerably extended CES activity in subsidising new employment is anticipated.

Regional measures are mainly related to the stimulation of the

development of areas of special national concern with tax breaks, favourable loans and HBOR guarantees. With greater activity from the newly-founded Regional Development Fund, the development of a large number of undeveloped regions in Croatia will be assisted. Regulations about incentives to island and mountain/hill country development are in force, but there are still quite a lot of bureaucratic obstacles in the way of their proper implementation.

Finally, attention should be drawn to the fact that the amount of state aid in Croatia is large. Only subsidies from the national budget in 2000 came to 2.4% of GDP. For the same of comparison, all forms of state aid in the same year in EU countries came to 0.99% of GDP (ranging between 0.46 to 1.44% in the individual countries), and the demand has been made that they be additionally reduced by 2003. Only subsidies from the national Budget in Croatia are two and a half times as great as total state aid (subsidies, assisted loans, tax incentives and so on) in EU countries. It is thus to be expected that the EU will insist that Croatia cuts its spending on state aid and redirects what remains to horizontal targets at the expense of sectoral and ad hoc aid. An EU demand that Croatia found a body to monitor and implement state aid would increase the transparency of the system of state aid, and would make the monitoring and analysis of, as well as state policy with respect to, state aid easier. Croatia will, then, still be able to give state aid, but will gradually have to bring it into line with EU requirements. The first step in this process is the implementation of the provisions of the SAA that should be accomplished during 2002, thus making the aid system much more transparent.

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[i] *In this paper the term state aid means a form of state intervention, while the term subsidy has a narrower meaning and indicates only one form of aid, that is, a direct aid from the budget.*

[ii] *The statement of Mr. Božidar Pankretić, Minister of Agriculture , is quite telling: "Why should someone sow wheat at all if he can't get subsidies?" (Statement for Vjesnik, printed in Jutarnji list, 30 June 2002 p. 10).*

[iii] *This part is largely based on European Commission, 1999, and Commission of the European Community, 2002.*

[iv] *For a more precise description of these criteria see the European Commission, 2002.*

[v] *All sectors and firms are helped equally by horizontal measures, while sector- and region- specific measures assist only selected firms and regions.*

[vi] *It should be noted that this amount covers aid that individual countries give their own economies, and not aid that is given from the EU budget. The amount, then, does not include aid to agriculture that the Union gives as part of the CAP, but only aid that individual members give to their own agriculture. It is this information that is of interest in*

this paper, since it is necessary to determine what Croatia needs to do in order to approach the policy of national aid that has been agreed on by EU countries.

[vii] *BINA Istria is a firm set up for the financing, construction and management of the Istrian Y – semi-motorway complex.*

[viii] *Some of this aid went to areas of special national concern, and has a regional character.*

[ix] *Described in Tax incentives.*

[x] *For a more detailed calculation of this difference, more figures would be required, and they could not be collected in a short period of time.*

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Chapter 6

THE EUROPEAN UNION AS DETERMINANT OF CROATIAN TRADE POLICY

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ABSTRACT

This paper identifies the degree to which the Republic of Croatia is prepared for EU integration in the area of trade and trade policy. According to a comparative analysis of the extent of integration into the European market, of Croatian trade policy and the policies of applicant countries, as well as of the conditions placed before the applicants by the EU, and the specific features of the EU trade regime, we determine where Croatia is relative to the other applicants. The next section identifies the key measures that need passing in the Republic of Croatia for adjustment to the EU and its trade institutions and to facilitate the free movement of goods between Croatia and the EU. The conclusion is that during the transition period, the reforms necessary for joining the EU were not carried out, and that progress is slower than in the other applicant countries. However, since Croatia started the EU convergence process at a higher level of development than some of the applicants, this lagging behind in the preparations for accession have not entirely wiped out the "first-mover" advantages of Croatia. The question arises, however, as to whether these will completely disappear with the first phase in the imminent enlargement of the EU.

Key words:
Croatia, EU, WTO, trade, tradepolicy, natural trading partner

INTRODUCTION

The focus of this paper is on the impacts of EU-related factors on trade policy in the Republic of Croatia. This impact will be gauged by an analysis of the intensity of Croatian trade and integration into the EU, by an analysis of the adjustment of Croatian trade policy and regulations for the purpose of preparation for association, and an identification of the specific features of the EU trade regime with third countries. The paper starts with a determination of the criteria for EU membership, and a review of the level to which these criteria are met in the Republic of Croatia. On the basis of this review, which, to the extent possible, is founded on quantitative indicators, the initial situation in Croatia with respect to the EU is determined, i.e., how much Croatia meets those conditions for membership that relate to trade policy. The identification of the current situation serves as a point of departure for an analysis of the further preparations of the Republic of Croatia for joining the EU, primarily those capable of enabling the free movement of goods between Croatia and the EU, and adjustment with the EU trade regime with third countries. And then based on this analysis, we identify the factors that are slowing down integration of the Republic of Croatia into the European market and follow this up with recommendations for those responsible for trade and economic policies in the country.

TRADE POLICY AND CRITERIA FOR MEMBERSHIP IN THE EU

A trade policy is the system of laws, regulations, international agreements and negotiating positions that some state applies in order to be able to provide a legally binding market approach for domestic producers. The trade policy of each country is always, by definition, nationalistic, because the foreign product or producer is always discriminated against for the benefit of the domestic. One of the important tasks of the international trade system (GATT/WTO) is to minimise and forestall the uncontrolled employment of the discriminatory trade

policies of given countries. For this reason, member states of WTO do not have full freedom from the point of view of formulating their own trade policies, but have to follow the principles, rules and obligations agreed upon among member countries and translated into agreements.[i] These agreements, of course, do allow every state to a certain extent to respect distinct national (social and economic) interests.[ii] This goes for both the Republic of Croatia and for the EU. Thus the trade policy of the EU (ever since its origins in the Treaty of Rome) has been guided by: a) the need to accept GATT/WTO rules; b) the need to satisfy the objectives of common policies at EU level (such as the CAP); c) the need to replace the long-term non-existing common foreign policy; d) the need to satisfy the general goals of EU growth and development (including the narrower goals of protecting employment and economic structure). Similarly, Croatian trade policy is given shape within the context of the restrictions that are laid down by membership in the WTO and in regional trade agreements, and by its expressed intention to join the EU.

Trade integration into the EU and a specific kind of trade policy are not imposed as economic conditions for membership[iii], but do serve as elements for an evaluation of the level of preparation for membership in line with the methodology developed by the European Commission in the document Agenda 2000 (European Commission, 1997). Through this methodology, the Commission regularly, once a year, monitors the level to which applicants have met the membership criteria and their progress.[iv]

Price and trade liberalisation, the existence of a legal system, sustainable public finances and external accounts are some of the indicators according to which the first economic criteria about the establishment of an effective market economy in an applicant country are evaluated.[v]

The other economic criteria are a developed capacity to cope with competitive pressures and market forces within the Union. Meeting this criterion requires a minimum level of competitiveness in the main economic sectors of the candidate country. It means, among other things, the existence of an effective market economy; appropriate measures of government policy and legislation to stimulate competitiveness (trade policy, competition policy, state aids, support for SMEs), and the degree and the pace of trade integration a country achieves with the Union before the enlargement (the volume and nature of traded goods).[vi]

CONVERGENCE OF CROATIA WITH THE EU: ILLUSION OR REALITY

The remainder of this paper will analyse three groups of factors that are crucial in finding answers to the question posed in this heading. First is an analysis of the quantitative indicators of the degree of Croatian integration into the EU market. After that the formal, institutional indicators of the effects of trade and general economic policy are analysed: price and trade liberalisation, the existence of a system of trade laws and the implementation of adjustments for access to the single internal market. These indicators are selected in line with the methodology that is used by the European Commission in its Regular Reports on candidates' progress towards accession (see for example European Commission, 2002b); they are also defined as key areas for the implementation of the SAA (see for example Vlada RH, 2002, European Commission, 2002e).

The third group of factors that might reflect Croatia's degree of preparation for membership relates to other elements of the trade regime of the EU towards third countries and a comparison with the Croatian regime.

Trade integration

The EU is the most important trade partner of Croatia – 54% of the total foreign trade of the Republic of Croatia is with member states (Figure 1 and Table 1). However, the share of imports from Croatia in total EU imports in the transitional period (1993-2000) fell from 0.4 to 0.2%, without any sign of improvement in the structure and scope. The structural change index for Croatian exports altered less than in the applicant countries (Table 2), and it is still mostly textile and chemical products that are exported. The value of exports to the EU rose by 12.4%, while that of imports almost doubled, which led to a rise in the bilateral trade deficit (Figure 1).

Figure 1. Croatian imports and exports, 1993-2001 (billion USD)

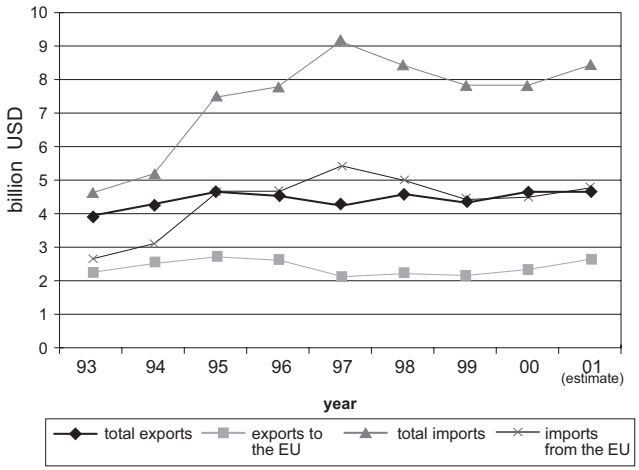

Table 1. Croatian imports and exports, 1993-2001 (billion USD)

	1993	1994	1995	1996	1997	1998	1999	2000	2001 (estimate)
Total exports	3.9	4.3	4.6	4.5	4.2	4.5	4.3	4.6	4.6
Exports to EU	2.2	2.5	2.7	2.6	2.1	2.2	2.1	2.2	2.5
Total imports	4.7	5.2	7.5	7.8	9.1	8.4	7.8	7.8	8.4
Imports from EU	2.6	3.1	4.7	4.6	5.4	4.9	4.4	4.4	4.7

Source: DZS, 2002.

Volume of trade, i.e., the changes in market share, 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 the level of competitiveness. Since the share of Croatian products in the EU markets is falling (see column 4 of Table 2), and the structure (column 2 of Table 2), or the size is not taking a desirable direction (Table 1 and Fig. 1) it can be concluded that the competitiveness of Croatian products in the EU market is diminishing too, which necessarily weakens the degree to which Croatia meets the membership criteria.

As against this, the countries of CEE have increased their shares in total EU imports, from 7.8% to 13%, they have changed the structure of exports (Table 2), i.e., increased their ability to meet the com-

petitive pressures on the EU market and have thus come closer to meeting membership conditions. For example, Hungary, which in the last Commission reports was placed among the most successful applicants, increased its exports to the EU from 4.9 billion euros in 1993 to 24.2 billion euros in 2001. Alongside volume, the nature of trade is also a measure of trade integration with the EU. Thus more vigorous intra-industry trade in products with a high degree of value added is an indicator of similarity of productive structures (Landesmann, 1995), and is followed with fewer troubles (lower adjustment costs) when a country joins the EU. For this reason, the extent to which total trade is based on intra-industry trade can be considered to indicate a higher level of satisfying the conditions for membership. The level of intra-industry trade can be estimated by the Grubel-Lloyd index.[viii] According to this indicator, Croatia can be considered comparable with the second round of applicants (see column 3, Table 2).

Table 2. Selected trade indicators[vii]

Candidate country	EU export structural change index	Grubell-Lloyd index (%)	Exports to the EU as a share of total EU imports (%)		Imports from the EU as a share of total EU exports (%)		Relative trade balance (%)
	1994-1998	1998	1993	2000	1993	2000	2000
Hungary	5.3	73.37	1	2.4	1.4	2.4	-6.20
Poland	4.3	49.63	1.8	2.6	2.4	3.6	-21.16
Estonia	0.8	45.86	0.1	0.3	0.1	0.3	-13.45
Slovenia	1.1	71.93	0.7	0.6	0.8	0.9	-6.20
Czech R.	4.6	70.13	1.2	2.5	1.5	2.8	-9.24
Bulgaria	0.7	40.77	0.2	0.3	0.3	0.4	14.27
Latvia	0.5	26.78	0.2	0.2	0.1	0.2	-26.14
Lithuania	0.6	30.23	0.1	0.3	0.1	0.3	-8.76
Romania	1.7	35.88	0.4	0.9	0.5	1.1	-11.48
Slovakia	2.0	60.79	0.3	0.8	0.3	0.8	-10.86
Macedonia	-	24.46	0.1	0.1	0.1	0.1	-22.48
BH	-	23.61	0.007	0.05	0.02	0.12	-58.95
Albania	-	36.85	0.02	0.03	0.1	0.1	60.27
Croatia	0.5	36.85	0.4	0.2	1.8	0.5	-30.77
FRY	-	-	0.0004	0.1	0.01	0.02	-52.34

Source: COMEXT, 2002

In its trade with the EU, Croatia has a relative trade deficit larger than all the applicants. The Czech Republic, Hungary and Slovenia have relative trade deficits comparable with the EU overall trade deficit[ix], while the indicators for Croatia are comparable with Latvia, and just somewhat better than the other countries of the western Balkans (see column 6 in Table 2).

At the same time, the applicants have mainly increased their shares in the EU market, the increase being correlated with a change in export structure (columns 4 and 2 of Table 2) and with the level of intra-industry trade. Commission reports show a strong positive correlation between change of export structure and level of GL index on one hand and applicant progress on the other. As for Croatia, its market share has dropped, export structure has remained unchanged, and its exports are less differentiated than in the more advanced applicant countries. It is mainly traditional, labour-intensive products with low value added that are exported from Croatia to the EU (textiles, timber, wood products and so on).

In accordance with this it can be concluded that our progress towards satisfying the criteria for membership is very meagre and that Croatia is at the level of the less advanced applicants.

Other indicators, for example openness indicators, also lead to the same conclusion about Croatian non-convergence with the EU. In line with the traditional theory of international trade, openness implies rationalisation of the productive system and enables optimal resource allocation, and suggests a potential for rapid growth and restructuring. Total trade as a proportion of GDP [(export + import)/GDP] is one of the indicators of the degree of openness of an economy. Other applicants mainly show a high degree of openness, which also has a tendency to rise, while the degree of openness of Croatia is comparable with that of Romania and Poland (Table 3). The signs of a rise in openness and of other indicators (which could not have been encompassed by this paper) in 2000, may indicate that stagnation has ended and reform started.

Table 3. Degree of openness of Croatia and some other applicant countries, 1997-2001 (%)

	CRO	LIT	LAT	EST	BUG	POL	ROM	SVK	SLO	HUN	CR
1997	65	120	111	168	112	55	65	122	116	91	119
1998	59	112	116	170	94	62	53	129	115	103	119
1999	60	99	98	159	95	59	61	126	109	109	123
2000	69	95	100	192	117	66	72	146	122	127	143
2001	-	102	101	185	119	63	75	161	121	123	145

Source: Calculated by A. B. according to DZS (2002) and DG Trade (2002)

Is the EU a natural trade partner for Croatia?

According to the basic idea of the "theory" of natural trade partners, regional trade liberalisation among countries that are "natural" trade partners will not lead to any considerable "trade diversion".[x] A natural trade partner is defined as that with which some country (Croatia, for example) has ample bilateral trade without there being any trade policy incentives. Hence it is necessary to define the determinants that enable a large volume of trade among countries. For an analysis of the volume of trade, the so-called gravity model is used. This model, by the simplest specification, explains the volume (and geographical structure) of the bilateral trade flow for a given country (or region) with different partners, using a series of explanatory variables: a) GDP or per capita GDP of the trade partner countries, b) trade barriers such as transport and other *trading costs* (defined by the distance between the countries), and c) factors that foster trade, such as a common border, common language, common legislation and so on.

By testing the gravity model[xi], however, it is impossible to determine with a high degree of confidence that geographical closeness or distance is a key variable in determining the natural trade partner. Accordingly, when the Republic of Croatia decides on trade liberalisation with the existing regional blocs, the crucial factor in the choice of bloc to which one ought to open up cannot be distance but the economic strength of the bloc itself. The higher level of GDP in EU members than in members of CEFTA and the western Balkans shows that the EU is the regional bloc with which liberalisation of trade would lead to a greater increase of national prosperity. What is more, with EU enlargement, this partner will become still more natural.

Institutional indicators of convergence

Price liberalisation

The use of administered prices in Croatia is limited to agricultural products, energy and transport. This level of price liberalisation, according to the criteria of the European Commission, is considered advanced, and is comparable with applicant countries that meet the criteria for the existence of an effective market economic (European Commission, 2002e).

Trade liberalisation

Liberalisation of trade in the Republic of Croatia to date is a reflection of membership in the WTO and the conclusion of free trade agreements (bilateral[xii] and with EFTA) and the intention to join the EU.

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 OECD countries by the year 2005. Export and quantitative restrictions or measures that have a similar effect have been abolished.

Trade with the EU is regulated by the Interim Agreement that enables application of the commercial provisions of the SAA until the process of ratification is completed. The Interim Agreement contractually regulates trade preferences somewhat more favourably than those that were applied to Croatia from the collapse of the SFRY onwards. That is, the institutional links between Croatia and the European Community were regulated up to 1992 by the same instruments that were joining the SFRY and the Community. Pursuant to the Cooperation Agreement Croatia had preferential access to the market of the European Community, and also a preferential position vis-à-vis other states in the region (cf. Samardžija, 1994; 160-169).

According to the currently valid 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 trade in industrial products has been liberalised; trade in textile and steel products will gradually be liberalised by 1 January 2006, and by 1 January 2007 trade in all other industrial products. With respect to agricultural products, 75% of the trade will be liberalised by 1 January 2006, 41% by the abolition of customs duties and 34% by preferential treatment covering traditional trade. By the end of the transitional period, trade in processed agricultural and fish products will have been totally liberalised (European Commission, 2002e).

States that are applicants for membership liberalised their trade with the EU in line with the provisions of the Europe Agreements by 1 January 2002. To reach this level of integration with the EU, in line with the provisions of the SAA, Croatia will need another five years.

Along with liberalisation of trade with the EU and attempts to enter CEFTA, Croatia has bound itself to join in regional free trade zones in the west Balkans. The establishment of regional cooperation

became a standard provision of agreements between the EU and third countries (e.g., the European Agreements, the Euro-Mediterranean Agreements concerning associated membership, the Cotonou Convention[xiii], for more see below). This form of cooperation was achieved by applicants by the creation of CEFTA, and completion of negotiations about a free trade agreement with FRY and Albania is awaiting Croatia, and perhaps the making of the bilateral free trade agreements multilateral.

The system of trade laws

The basis of the EU is a single market, in which, in conditions of free competition, there is a free movement of goods, services, capital and people. Hence, for convergence with the EU, application of the rule of market competition on the one hand, and transparent, limited state aid on the other, are crucial. Like the states of CEE, Croatia is faced with difficulties in the establishment and implementation of a legislative and institutional framework necessary to set up an effective market economy.

According to the provisions of the SAA (Article 70), in the trade relationships between the EU and Croatia, the rules of market competition and state aid according to Union legislation will be applied. Most applicants, in this area, have to develop or adjust their rules about the allotment of state aid and step up provisions for the prevention of the restriction of competition and the abuse of a dominant position on the market. For the sake of a satisfactory implementation of the SAA, Croatia ought by the end of 2002 to have set up an independent agency for state aid, and an agency for the protection of market competition should have been expanded and be able to control mergers.

Preparation for integration into the internal market

Since through the Europe Agreements the applicants set up free trade zones with the EU, further liberalisation measures mainly relate to integration into the single European market. Future measures will relate to the abolition of border non-tariff barriers: physical, technical and fiscal. The further integration of candidates takes for granted the adjustment of economic policy with that of the current member states and the acceptance of the standards and rules of the Union (the acquis).

Gradual adoption of EU legislation in the area of standardisation, metering, certification and accreditation is an obligation that Croatia took upon itself by signing the SAA. The State Bureau for Standardisation and Metering, in cooperation with the Ministry for European Integration and the Legislation Office, is drawing up a national strategy for the adoption of the technical legislation, while the application of standards is not obligatory.

It took Austria, Sweden and Denmark three years before joining the EU to adopt measures of this kind (Baldwin; Francois, Portes, 1997).

EU trade policy

The current common trade policy of the Union is mostly beyond the control of the member states (although the effects of the policy have of course a direct effect on their economies).[xiv] Following the principle of creating "an open market economy with free market competition" the policy has a different effect on the member economies with different economic structures and various degrees of dependence on trade with the world (for more detail, cf. Messerlin, 2001). The common trade policy can be analysed from several aspects: the level of protection that is afforded to member states, its use for the purposes of other Union policies (agriculture, industry, development, competition, foreign policy), the preferential nature of the policy and so on. Although all aspects of trade policy are very important for applicant states, here we shall deal only with the nature of trade policy towards non-member countries as well as with the possibility that applicant countries make an impact on adjustment of this regime to meet their goals and strategies in the current round of negotiations within the WTO.

The widely-popularised characteristic of Union trade policy is dependence on *discriminatory* or *preferential* trade agreements that started to develop as early as the Treaty of Rome. Thus in 1999 the EU had contractual and reciprocal bilateral agreements with 22 countries and contractual but non-reciprocal bilateral agreements with 77 countries. This means that the EU is the source of 40% of all preferential trade agreements reported to the WTO, and if EFTA and CEFTA are included, the common contribution to the creation of preferential arrangement grows to two thirds of all such agreements in the world (Messerlin, 2001; 197). A particular feature of these agreements is their differentiated levels of preference, which has become known as the trade preferences

pyramid. The pyramid contains six levels: trade partners without most favoured nation treatment (MFN), the then socialist countries that were non-members of GATT; trade partners with GATT MFN status – members of the OECD outside the Union; trade partners to which the General System of Preferences, GSP, was applied; trade partners in the Mediterranean; trade partners with the status of developing countries – ACP states and, finally, trade partners with the highest preferences – EFTA countries the only ones that had reciprocal preferences (a free trade area for industrial products).[xv] This pyramidal structure was greatly modified by a change in the EU regime towards the central European countries (but then again, not so much to disappear completely – see Table 4 which illustrates the remains of the pyramidal construction of import tariff protection in the EU). Candidates for EU membership have gone from the lowest preference status to practically the highest level along with EFTA and members of the European Economic Area, EEA, which has had an adverse effect on the relative position of the groups of countries who previously had greater margin of preference than them. At the same time, the character of the regime was changed, and no longer had dominantly non-reciprocal preferences but instead it had dominantly reciprocal preferences (except for the least developed countries – with no time limit, and for ACP starting in 2008 with a 12 year transition period) consistent with WTO rules.[xvi]

Table 4. Remains of the trade preferences pyramid of the Community, 1999.

	Simple average of import tariff rates (%)						
Product	MFN related	MFN applied	GSP +MFN	FTA +MFN	LDCs +MFN	Lomé[c] +GSP +MFN	Lomé[c] +LDCs +MFN
All products	7.0	6.9	4.9	3.5	1.9	1.9	1.8
Agricultural products[a]	17.4	17.3	15.7	16.7	10.3	10.3	9.5
Non agricultural products[b]	4.6	4.5	2.3	0.5	0.0	0.0	0.0

FTA - free trade area.
GSP - general system of preferences.
LDC - least developed countries.
Lomé - ACP countries (African, Carribean, Pacific countries).
MFN - most-favoured nation.
[a] *As defined in the Annexe I WTO agriculture agreement.*
[b] *Remaining products.*
[c] *From 2000, the Lomé Convention was renamed the Cotonou Partnership Agreement.*
Source: WTO, Trade Policy Review: The European Union, 2000 (cf Messerlin, 2001)

Notwithstanding the "promotion" in their trade status, the candidate countries are faced with very high costs (related to the static effects of liberalisation on the creation and diversion of trade) for two reasons. Firstly, the *real* improvement in preferential treatment (difference between the MFN customs rate and the 0% rate) is not particularly important, because a large number of such countries already had a relatively free approach to the EU market for non-sensitive products. One exception, of course, is textile products and clothing, which for six central European countries have since 1997/987 been exempt from customs and quotas. At the same time, a positive effect of the preferences is derogated by the complex rules of origin.[xvii] Another cause of the high costs of liberalisation is change in applicants' trade policy towards the non-EU countries in the pre-accession period. Candidates, that is, have reduced trade barriers against EU member states (and against other candidates in their trade with each other) but have often compensated for this by increasing the level of protection vis-à-vis countries that are not members of the EU. Since the likelihood of the trade diversion effect is thus increased, this approach to liberalisation does clearly not have to have a positive effect on the welfare of the candidates.[xviii]

All candidate countries, after entry into the EU, have to accept all the existing regulations, but will be able to take part in the making of any new rules. For this reason it is in the interest of the current members to make sure that new agreements within the WTO include provisions which assure the accomplishment of their objectives in the future, provisions that do not necessarily suit the candidates. For this reason one has to consider how much does the stance of the candidates with respect to multilateralism and the functioning of the WTO coincide with that of the EU. If the degree of concurrence is not great, to what extent can the candidates have an impact on the modification of the European position?

An EU delegation went to the ministerial meeting in Doha (November 2001) with clearly delineated objectives for the new round of negotiations within the WTO. These, put most concisely, include (cf. European Commission, 2000) further liberalisation of and access to the market for goods and services *not* relying on a sectoral approach, improvement of WTO rules by the inclusion of new areas such as investment, competition and advancement of trade, promotion of sustainable development and the more direct regulation of matters that arouse public interest, such as the effect of trade on the environment.

Unlike the EU, the candidate countries (including Croatia) did not have in Doha any *formal* common position (except informally, e.g., CEFTA plus). From the published positions of each individual country (www.wto.org) it would appear that their goals in the new round of negotiations are close to EU objectives. Taking into account the very different levels of development and of economic structures of the candidates as compared to the EU mean, this relative overlap of goals shows that the candidates are not ready, or are not powerful enough, to initiate questions in a multilateral forum that are in their interests and might be against the stated aims of the EU (for instance, in the area of investment, TRIPS and so on).[xix] From a review of the trade policies of the candidates, it would seem that they are trying to replicate EU trade policy not only in the area of protective instruments but also in forming bilateral preferential arrangements (as against relying on multilateral liberalisation). The level of protection, though, is not in agreement with the EU level (although similar, they are on average very different for individual groups of products). When the level of protection in the candidate country is higher than in the EU, a good strategy in this round of negotiations would be to approximate to a lower EU level. If the candidate already has protection equal to or lower than the EU, the question arises of whether the candidates can "force" the EU, while negotiation the accession, to come down to their level of protection, or leave it the option of paying compensation to WTO members when acceding candidates will have to adopt the higher level of the EU protection.

CHALLENGES IN ADJUSTMENT TO THE EU

The preceding analysis leads to the conclusion that Croatia is slower than the other applicants in carrying out reforms necessary for accession to the EU. From this analysis it also derives that the EU is a "natural" market for Croatia and that it, like the candidates, is not willing at the moment to carry out any particularly different trade policy than that being run by the EU.

For this reason we shall identify the factors that might positively or negatively affect the further convergence of Croatia to the EU. The imminent process of EU enlargement is very important. Although it is not clear what the EU will be like after this enlargement, one of the possible scenarios is that the willingness of a new EU with 20 mem-

bers for new enlargement will be much smaller. Taking this scenario as a possible one could well reduce Croatian motivation for the implementation of reforms already provided for. In addition, the most marked comparative advantages of producers in Croatia lie in the production of traditional products (fisheries, wood and textile products), in which the competition will be increased with the accession of new transitional members.

For this reason, during the period of adjustment to the EU, it is necessary to consider adjustments to an enlarged EU, i.e., an EU of 20 to 28 members, and of acceding to this much larger union when the conditions are met.

In spite of the high possible costs of integration (restructuring costs), the establishment and consistent implementation of obligations taken on can help in the creation of favourable investment conditions. The establishment of free trade zones in the region will make it possible for transitional economies to prepare to face the competitive pressures on the EU market. The strengthening of inter-regional trade can make specialisation possible and facilitate its heading in the direction of activities with greater value added.

Although access to the EU market is unlimited and duty-free for *most* of the Croatian products, this kind of regime of access to the EU market does not make it possible to adjust the export structure of the Republic of Croatia in accordance with its comparative advantages. That is, Croatian producers have their greatest comparative advantages in sectors in which access to the EU market is limited. These are fisheries and the production of tobacco products.

Regional cooperation, which Croatia is obliged to carry out by the SAA, can help in the process of restructuring. At the same time, the introduction of the regular reports made by the European Commission enables unbiased and consistent monitoring of the implementation of reforms.

RECOMMENDATIONS

- Work on the achievement of status of full member as fast as possible, because this will minimise the static costs that derive from partial liberalisation through implementation of the SAA. The proviso is that the implementation of the SAA and other international obligations and reforms already launched is a necessary condition for transformation.

- As opposed to the position of Croatia in Doha, not to enter into numerous bilateral preferential arrangements, especially if each of them has separate rules of origin – this only increases the transaction costs and trading costs. Existing bilateral agreements could be made multilateral, which would reduce the administrative costs of implementing and monitoring them.
- If the trade policy of the EU is accepted, it should be used, as in the member states, as a support for development, industrial and competition policies and not as a merely passive protection policy.

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[i] *The basic agreements are those of trade in goods (GATT), in services (GATS), the protection of intellectual rights (TRIPS) and the settlement of disputes (DSM).*

[ii] *This is put into practice by devices ranging from exceptions to the need to respect the basic principles of the most favoured nation and national treatment (e.g., Article 24, Special and Differential Treatment for Developing Countries) to failure to respect recommendations about not using quotas, standards and so on for the protectionist purposes.*

[iii] *Of course, by associating, an applicant country obliges itself gradually to create a free trade zone and adjust its trade policy with the common trade policy of the Union. The adjustment of applicants to the EU trade policy is monitored in the context of the general legal adjustments. Accession negotiations progress according to the pace of harmonisation to the acquis. Acceptance and implementation of the acquis implies that the applicant has developed the ability to take on the obligations that arise from membership. The negotiation chapters that relate to trade are: the free movement of goods (Chapter 1), the free movement of services (Chapter 3), the free movement of capital (part of Chapter 4), the negotiations of some states about the protection of intellectual property (TRIPS, Chapter 5), and the establishment of the customs union (Chapter 25). Most of the applicants have provisionally completed negotiations about these chapters, which means that they will in the event that they do join the EU, be involved in the single market and apply the common customs tariff with respect to third countries, i.e., they will become a member of the customs union.*

[iv] *It also issues the Regular Reports as they are called. For more details see: http://europa.eu.int/comm/enlargemenet/report2001/index.htm#/Regular%20%20Reports*

[v] *Other elements according to which the European Commission evaluates the effectiveness of a market economy are: the equilibrium between supply and demand established by the free interplay of market forces; absence of significant barriers to market entry (establishment of new firms) ond exit (bankruptcies, liquidations); the legal system, including the regulation of property rights ; macroeconomic stability achieved, including price stability, sustainable public finances and external accounts; the existence of a broad consensus about the essentials of economic policy, and a sufficiently developed financial sector to channel savings towards productive investment.*

[vi] *The other elements according to which the capacity to cope with competitive pressures within the Union are evaluated are the sufficiency of available resources with acceptable costs (human potential, capital and infrastructure) with the possibility of their being developed and built upon (education, research), as well as a considerable proportion of SMEs being involved in EU trade, because according to experience to day, such companies tend to benefit more from improved market access, and partly because a dominance of large*

firms could indicate a greater reluctance to adjust. (European Commission, 1997).

[vii] *The figures given in the table are illustrative, and selected on the basis of a large number of figures from the 1993-2000 period.*

[viii] *This index, for some industrial product or economic activity "i", is usually defined as* $GL_i = 1 - [|Ex_i - Im_i| / (Ex_i + Im_i)]$ *where Ex indicators exports and Im imports. The closer the index is to 1, the greater the level of intra-industry trade.*

[ix] *Relative trade deficit is defined as (x-m)/(x+m), where x is exports, and m is imports, expressed in percentages.*

[x] *Trade diversion is expressed as the cost for a country that, because of the existence of a formal trade agreement, diverts imports from a country that produces them efficiently to a member country that is less efficient , and at the same time ceasing to charge import duties therefore forgoing import tariff revenue.*

[xi] *More about the model used and the econometric results of the test available from the authors.*

[xii] *In spite of the fact that bilateral agreements have not been ratified, the following agreements are being provisionally applied: with BH (from 1 January 2001), Macedonia (1 July 2002), Slovenia (1 July 2002), Hungary (1 April 2001), Czech R (1 January 2002), Slovakia (1 January 2002) and EU member countries (from 1 January 2002). Agreements have been signed with Turkey and Poland, and negotiations with Albania, FRY and Romania are under way.*

[xiii] *In 2000, the IV Lomé Convention ceased to exist , and the EU signed a new agreement, the Cotonou Partnership Agreement, with African, Caribbean and Pacific (ACP) countries.*

[xiv] *Trade policy, in line with the Treaty Establishing the European Community, consolidated version after the Treaty of Amsterdam, 1997, OJ C 340/173 or europa.eu.int.eur-lex/en.treaties/dat/ec_cons-treaty-en-pdf is considered one of the forms of commercial policy and is clearly defined with respect to wider commercial policy. Control of trade policy is within the jurisdiction of the Union, i.e., member states do not have a direct control over it. EU institutions can carry out trade policy measures independently without consulting the member states , and trade agreements are ratified only at the level of the Union (there is no need for members to ratify them). As against this, control of commercial policy is divided between the Union and the member states, which have more freedom in the area of regulation commercial presence and trends in production factors (cf. Messerlin 2001 Chapters 4 and 5).*

[xv] *The first three levels were set by the EU unilaterally, and any of the more advanced status was conditional upon contractual relations with the EU. The ACP developing countries were given trade preferences within the context of the EU development policy.*

[xvi] *The transformation of the regime, from non-reciprocal to reciprocal preferences, is based upon the formation of new bilateral or regional preferential arrangements consistent with WTO rules (especially Article 24).*

[xvii] *For example, it is sometimes cheaper to pay a tariff than to bear the costs of proving the origin of the goods (Mayhew, 1998).*

[xviii] *The level of protection against non-members of the EU may rise because of the process of joining the EU. For example, when Slovenia joins the EU, the provisions of the free trade agreement between Croatia and Slovenia that enable the duty free and unlimited imports of wine from Croatia into Slovenia will have to be abolished .*

[xix] *This is a judgement that still needs support in a more thorough analysis, which alas could not be included in this paper.*

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Chapter 7

PREMISES FOR THE INCLUSION OF AGRICULTURE IN THE PROCESS OF CROATIAN ACCESSION TO THE EUROPEAN UNION

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ABSTRACT

The Republic of Croatia, in comparison with most other transitional countries, is late with its preparations for future accession to the EU. The causes of this kind of situation are objectively grounded, the recent historical circumstances, as well as subjective in nature, the slowness and lack of political will to cope with this option. In recent times, particularly after the signing of the SAA, activity has been stepped up. In the adjustment process, Croatia will accept liberalisation of EU products and endeavour to retain certain privileges, depending on the sensitivity of the particular product. Further harmonisation of the agriculture legislation is required, although the major part of Croatian law relating to agriculture contains conditions and key measures found in the secondary legislation of the EU. In the paper, with the use of the methods of economic analysis and indicators of state intervention in agriculture and the costs of domestic resources, an evaluation is made of the advantages and limitations of Croatian agriculture.

The results of comparative analysis give a more objective image of the domestic agricultural sector in the international environment. Adjustment of agrarian policy should lead to an improvement in the competitiveness of domestic agriculture and at the same time to a preservation of domestic natural resources.

Key words:
agriculture, resources, agrarian structure, family farms, agrarian policy, rural development, economic integration

INTRODUCTION

As compared with most other transitional countries, the Republic of Croatia is late with preparations for joining the EU at some future time. The causes of this state of affairs are both objective – the Homeland War – and subjective – the slowness in coming to a political decision to go in for this option. In more recent times, especially after signing the SAA, activities, formal decisions and individual agreements with the EU have taken on speed, although Croatia still needs to put in a good deal of effort to catch up with the level of the countries in the first round for joining. The ultimate outcome for these countries, and for Croatia too, in the current mood of problems surrounding the enlargement depends more on the EU itself than on future entrant countries. In this context, a special consideration is given to the economic sectors of these countries and of Croatia that are of greater sensitivity and on which the shocks of integration will have a more profound and debilitating effect. Historically looked at, from the pre-accession experiences of the current members of the EU, it can be seen that the food and agriculture sector/s require a very sensitive analysis of the possible consequences of any future integration.

For this reason in the paper, along with a depiction of the conditions imposed by the EU for new member states to join, a diagnosis is offered of agriculture from the sense of the farm production indicators (and comparisons of them with those from the countries of CEE), as well as of the state of affairs in legislation and economic policy in these activities. Essential components of the discussion appear to be the matter of competitiveness, restrictions on increasing it, rural development, sustainable farm management and environmental protection, and the social aspects that make the farm sector incomparable with other economic sectors.

According to this review, the diagnosis of the vulnerability and an explanation of current limitations, in the conclusion a "view forward" is given, according to the currently known determinants of the EU, and a list is given of recommendations of things that need addressing in order for Croatian agriculture to converge on the conditions for membership set it by the EU.

ANALYSIS OF CONDITIONS FOR MEMBERSHIP IN THE EU

Today's European agricultural policy is marked by the many years of impacts made upon it not only by European but also by world political and economic events. In the 1970s it seemed that a global food shortage was imminent, the result being that politicians stimulated the production of food. Internal markets were protected, and subsidies rose. The situation changed in the early 1980s when the threatened shortages did not materialise. On the contrary, in international trade in farm products, the consequences of increasingly large stocks began to be observed, with falls in prices, high export incentives and increasingly numerous trade restrictions. There was an endeavour to find a solution in a new round of multilateral trade negotiations within GATT. In 1986 a new round of talks began, the Uruguay Round, as it was called, but the inclusion of agriculture into the talks was one of the most contentious of issues. The objective of the talks was to achieve greater freedom in the trade in agricultural products by a reduction of import barriers and export incentives, limitation of agricultural subsides and the unification of sanitary and phytosanitary regulations in international agreements. Such decisions became the foundation for the adjustment of agrarian policy measures in Europe and worldwide in recent times. There are endeavours to make up for the limitations in the market price policy by alternative incentives for the adjustment of the agrarian structure and for the development of rural areas and the preservation of the environment, because at the same time the deleterious consequences of the encouragement of intensive agriculture on the environment have been noticed, particularly in the more advanced countries.

The Common Agricultural Policy

The Treaty of Rome (1957), which founded the EEC more than 45 years ago, set forward the central place of agriculture in this start made to Western European integration. The common market for farm products required the passing of the CAP, because agriculture, along with transportation, is one of the two sectors in the EU for which there is a single united policy.[i] Agriculture is of primary importance in EU political matters; about three quarters of all legislative regulations are directly related to the legislative treatment of the agricultural sector. Not only is farm production dealt with: the regulations also handle the matters of the health and quality of food, and there are many extremely stringent regulations relating to veterinary matters, phytosanitary checks and ecology.

The CAP is founded on three principles, as follows. 1) The free flow of agricultural products within the EU, achieved by common EU prices, the general prohibition on imposts and subsidies and the harmonisation of technical regulations. 2) Preferences according to which EU products are treated preferentially in the internal market, as against imported products, achieved by import protection. 3) Common financing of agricultural programmes.

The main objective of the CAP is agricultural income support, and the general goals are: increasing the productivity of agriculture, providing a satisfactory standard of living for the farm population, stabilisation of markets, ensuring a dependable supply of agricultural products and making sure of reasonable prices for consumers. The basic policy instruments through which these goals are accomplished include price support, direct payments to farmers and control of supply. The current system is the outcome of two reforms. The first started in 1992 with a change in aid, from price support to direct payments; maintained prices were dropped, the appropriate direct compensations were designed and new measures for controlling supply were brought in. Later changes included the transformation of variable import dues into customs equivalents, and they were employed in 1995 as part of the obligations of the EU within the Agriculture Agreement of the Uruguay Round. The second reform of the CAP, Agenda 2000, was adopted in 1999, and started to be implemented in early 2000. This meant a turnabout in the EU, from price support to direct payments and the adjustment of measure for the control of supply.

Up to its reform in 1992, the CAP was primarily a system of price arrangements supporting the incomes of EU farmers in two ways: 1, the government would buy up supply surpluses when there was a danger that

market prices might fall below an agreed minimum (the intervention price) and 2, customs were applied at EU borders, the consequence being that imported goods with a high degree of price support could not be sold in the EU below the desired internal price set by the EU. Although political reforms cut the price support for some farm products, the EU still applies a relatively high border protection for some products, such as milk, sugar and beef.

After the reform of 1992, along with price support, direct payments to producers were provided for in order to support their incomes. These compensatory payments were established as part of the 1992 package and are based on the volume of production, but are given to farmers on the basis of their productive acreage in areas in which a certain yield is traditionally obtained. The 1992 reform also brought in a system for controlling supply via a mandatory set-aside programme, according to which farmers would take some of their fields out of production.

Agriculture support programmes mean earmarking considerable sums of money from the EU budget. Expenditure for agriculture rose from ca 5 billion ECU in 1975 to 45 billion ECU in 1998, not including the individual expenditures of EU members on agriculture. About 49% of the EU budget is set aside for CAP measures[ii], and in previous years this share had been as much as 70%. High budgetary expenditure for agriculture in fact brought about a budgetary crisis, and hence led to several political reforms for reining in the considerable outlays on farming.

Measures of agricultural policy affect the functioning of the agricultural market of the EU. Within the set of the legislative provisions for the competitiveness of the market they work via transactions between private buyers and producers. As WTO member the EU has agreed to reduce its export incentives and its customs duties, as well as to limit the level of its domestic aid. Such restrictions have a powerful effect on agricultural policy, the level of agricultural supports, and the methods in which support is given. It can be expected that the next round of WTO talks will result in additional demands for CAP reforms. The enlargement of the EU will also have a powerful effect on agricultural policy, because the budgetary costs will become too large for it to be maintained. Instead of by market price supports, the farm sector will be aided by direct payments, most likely tied to natural resources (the environment) or the level of agricultural income, and not to actual farm production. Nor can the current form of payment according to acreage of productive land be a lasting solution. In the EU it is increasingly obvious that the health of the agricultural sector depends on the chances of people finding employment in

the non-farm sector, starting off the process of the desirable structural changes. The legal provisions in this area refer to the great many special programmes, wide in scope, such as for irrigation, afforestation and regional programmes of incentives to agriculture in the underdeveloped areas. This particularly refers to the economic and social linkage of EU objectives to diminish the differences between regions, to aid to areas in which making a living in farming is more difficult, to areas of depopulation and so on. Increasing attention is attracted by the question of environmental protection, that is, the need to integrate concern for the environment into the agricultural policy of the EU. This can also be said of issues of rural development, and it is believed that in the future the CAP will develop into the Common Rural Policy for Europe (Žimbrek et al., 1999).

A COMPARISON OF CROATIAN AGRICULTURE WITH THE AGRICULTURES OF OTHER EUROPEAN COUNTRIES

The European Union

The land area of the fifteen EU members abounds in varied environments and is marked by great geological, relief and climate differences, which make possible the production of a broad-ranging supply of plant and animal products; the centuries-old inherited practices, together with the social and economic characteristics, have set their marks on the numerous production systems.

In the EU, 135 million hectares of agricultural land are cultivated. About 80% of this area lies in only five countries: Spain, France, the UK, Germany and Italy. Production too is concentrated in a limited number of countries, with 80% of all production being accounted for by six countries (France, Italy, Germany, Spain, the UK and Holland). In terms of monetary value, animal husbandry leads (40%) followed by fruit and vegetables (16%) and cereals (9%).

Within the EU there are considerable differences in the levels of farm income, both in given countries, and regionally. Farm economies are structurally very diverse. At base, two types of agriculture can be distinguished (Corvino and Mariani, 1999): *the southern European model*, in which there are small holdings run by mostly older farmers (most of them in Greece, Italy, Portugal and Spain) and the *northern European model*, with mainly medium-sized and large businesses (the UK, Germany, Den-

mark, France and Ireland). Particularly large farms, of more than 200 ha, are to be found in what used to be the DDR. These have developed on the base of the great collective farms of the socialist era, and they are run, mainly, by young farmers.

The countries of Central and Eastern Europe

In the countries of CEE, agriculture is relatively more important than in the EU countries with respect to land use, proportion in GDP and, particularly, in its share in overall employment (Table 1). Reforms of the beginning of the 1990s brought the privatisation and de-collectivisation of farming, creating a new structure for agriculture but, at the same time, a new dualism. In most of these countries the private ownership of farms, land and equipment was dominant, with the proviso that most of the new landowners were small farmers. Many studies have shown that it is these small farms that are a major limitation in the way of the development of the agriculture of these countries. Difficulties in the transformation of the economic systems of the CEE countries, taking them from being centrally planned to market oriented economies, have overshadowed the real capacities of the agricultural sector. The consequences of rejecting the command economy and bringing in price, production and trade liberalisation have led to a drastic fall in incomes, and hence a fall in the consumption of most food items. The decline in demand, together with the growing input prices, has reduced the production in most of the candidate countries well below the level of before the transformation.

One important corollary of market reform in these countries is a deterioration in the balance of trade with the EU. A considerable fall in farm output has reduced the possibilities of exports to the EU, which is, for most of the entrant countries, the most important trade partner. At the same time, the import of these products from the EU has gone up, partially because of changes in consumer demands with respect to products like tropical or western-style processed food (Josling and Babinard, 1999). Although aid to agriculture has gone up slightly in the CEE countries, because of intervention and foreign trade measures, in most cases the supported prices are still lower than those in the EU. What is more, the prices at the level of the farm (production prices) are, in the candidate countries, mostly considerably lower than those in the EU (according to data from 1995, producer prices in these countries ranged in the area of from 40 to 80% of the level of prices in the EU).

Table 1. The role of agriculture in the EU, some CEE countries, and in Croatia

	Farm land in 2000 (000 ha)	Farm production as percentage of GDP in 2000	Percentage of people employed in agricuture in 1997
EU-15	135,260	2.1	5.1
Czech R.	4,280	4.7	4.1
Hungary	6,195	4.5	7.9
Poland	18,443	5.0	27.4
Slovakia	2,443	4.9	5.8
Slovenia	792	3.5	6.2
Croatia	3,100	7.0	10.9

Sources: for EU and CEE: Deutsche Bank Research. EU Enlargement Monitor, December 2001; for Croatia: DZS, 2002

Table 2. Agriculture in foreign trade, 1997

	Foreign trade balance sheet (million USD)	As percentage of total imports	As percentage of total exports
EU-15	...	7.4	9.6
Czech R.	-653	7.8	5.6
Hungary	1,762	6.0	20.4
Poland	-469	10.8	10.4
Slovakia	-392	7.6	4.7
Slovenia	-449	8.8	4.3
Croatia*	-477	11.0	13.2

** Data for Croatia include the food and agriculture sector.*

Sources: Eiteljörge and Hartmann, 1999; Franić, 1999

Table 3. Agriculture protection indicators, 1997

	EU-15	Czech R.	Hungary	Poland	Slovakia	Slovenia	Croatia
PSE %	42,0	11,0	16,0	22,0	25,0	38,3	25,3

Source: Franić, 1999, apart for Slovenia: National programme for the developement of agriculture, food, forestry and fisheries, 200-2002

With the enlargement of the EU, the total area of agricultural land, with the new members, would by increased by 60 million ha, and would come to almost 200 million hectares. The number of people

employed would double, from the current ca 6.6 million, and the average area of available agricultural land per person employed in farming would come to 9 ha as against the 21 ha in the current EU. Inclusion of the CEE countries in the EU would considerably increase the proportion of the overall economy represented by the farm sector. In the years to come, it is expected that the big differences that exist between the candidate countries and the EU - in the relations in level of protection, the discrepancies in farm prices, legislation and application of internal market requirements – will make it difficult for these countries to implement the acquis unless transitional measures in some form are employed. A considerable pressure towards adjustment will be forced on these countries when they adopt CAP criteria, as well as on EU countries, which will have to find the financing resources in competition with the agricultural sector of the new members.

The attitude of the EU towards the candidate countries

In Agenda 2000, the European Commission proposed a new approach to the procedure for joining the EU. This relates primarily to pre-accession aid, not only from the PHARE programme (1.5 billion ECU a year), but also to aid for agricultural development (5 billion ECU a year) and structural reform (1 billion ECU a year). The European Commission has also adopted a decision concerning the allotment of funds meant for as aid during the accession period, *for agriculture and rural development*, in the CEE applicant countries. This aid relates to the period of accession and is in line with the *Regulation* of the European Council of 21 June 1999 – SAPARD (Special Accession Programme for Agriculture and Rural Development). The allotment of these resources will be grounded on the following criteria: the farm population, the agricultural area, per capita GDP, purchasing power and the specific situation of a given region. The decision of the European Commission about the distribution of the funds will enable the applicant countries to prepare plans to give aid to agriculture and rural development, according to the requirements emphasised in the provisions of SAPARD. Pursuant to these plans, the European Commission will approve agriculture and rural development programmes for each of the countries, the basic objective being assistance in the preparation of the agricultural sector for full participation in the CAP and the EU internal market.

The agricultural sector in Croatia

Trends in the agricultural land of CEE in the transformation period are almost precisely the same as those in the agriculture of Croatia. Certain differences in the characteristics of the domestic agricultural sector derive from the particular heritage of Croatia, which from a social and economic point of view differed quite a lot from the model of the CEE countries (particularly in the agricultural sector, considering ownership structure), as well as because of the aggression of the nineties that marked that period.

Because of all the comparative advantages, i.e., the state of development of agricultural resources, the land, natural and climatic advantages as well as water resources, Croatia has a bright outlook in the development of agriculture.[iii] With about 0.65 ha of agricultural, or 0.45 ha of cultivable land per capita it is one of those countries that are relatively rich in agricultural land; however, rational land use is hampered by a number of factors: the inherited problems of the fragmentation of private land, constant loss of agricultural land to built up areas, the until recently undefined way of managing the state-owned lands, the considerable share of untilled and abandoned land and so on.

About two thirds of all agricultural land is owned by family farms, and the remaining third is accounted for by state-owned land. More than 70% of these holdings have less than 3 ha, and as a rule this is made up of very small fields; the level of technology is low; and there are very few vital and market-oriented farms capable of standing up to the competition of imports.

The shock of the transition to a market economy in the agriculture and food industry too resulted in a fall of production and employment, indebtedness, technological backwardness, a deterioration in the balance of payments, and insolvency. Deferral of necessary policy reforms in certain areas and of stronger economic integration can partially be justified by the war. Alas, the cessation of the war brought no turnabout in the implementation of economic policy with respect to the countryside and agricultural producers, in line with their strategic importance. Farm policy in Croatia in the last decade has been characterised by an inappropriate system of financial and institutional aid; although it was officially on the side of the farmer, in practice, directly and indirectly, it still moves government money into ineffective and inert systems. High external costs of production, a rigid tax system, an absence of cheap capital, an irrational trading and distribution system,

and inadequate budgetary support are some of the main factors behind the fall in production, low level of self-sufficiency (below 60%), and high prices for agricultural and food products. The market for that most important agricultural resource, land, is restricted by the current disorder in the land registers, and the functioning of the market for agricultural and food products is limited by unfair competition and patchy legislation.

Something a bit more has been done in the recent period in the area of legislation and in reforms in protection of and incentives to domestic production. During the years, the scope and structure of products to which incentives are given have changed. In the new incentives system of 1999, plant production was stimulated by incentives given to producers according to productive areas (and not according to volume of products, as hitherto) and payments for laying down long-term plantations in fruit farming and viticulture, while animal husbandry was encouraged by payments for breeding stock and fat stock, particularly in the regions of special national concern. Altogether, 130 types of incentive were brought in. Since Croatia, like other new members of WTO, cannot employ export subsidies or special protective measures during the import of agricultural products, the competitiveness of domestic products on the domestic market is further jeopardised.

In analyses to date of domestic government intervention in agriculture, that is, of the model that held good until 1999, four indicators for an evaluation of agricultural policy applied to eight basic agricultural products and secondary products derived from them were considered (Franić, 1999).[iv] The basic products showed a very high level of protection (Table 3). The indicators show that some of the benefits achieved by price protection of agricultural production were passed on to the producers of the inputs, because the basic agricultural inputs were protected with very high customs duties. Most of the total aid was of the market price kind, and the causes of the reductions during the period were mainly changes in prices on the world market. Foreign trade protection of basic agricultural products was maintained at a high level even after the reform of 1999. The comparison tells us that in the protection of domestic agriculture, Croatia followed the trends of the applicant countries. This is perhaps in line with the Uruguay Round, but if we compare the protection indicators with those in the EU, it is clear that Croatia, like the other transition countries, will find it very hard to take part in the market competition with the much more developed and more protected agriculture of Western Europe.

POINTS OF VULNERABILITY

The competitiveness of Croatian agriculture

Like most other countries, including the EU as a whole, the basic aim of Croatian agriculture is to ensure food security to the population, to the greatest possible extent with domestic competitive products. The goals of domestic agricultural policy stress the need to achieve effectiveness in agriculture in the conditions of the world market competition as well as protection and development of the domestic rural area.

The results of analyses[v] reveal the basic limitations in the achievement of a higher level of competitiveness for Croatian agriculture: the monopolist position of input providers, the poor access to commercial loans, payments in kind, undeveloped market and institutional infrastructure, absence of economy of scale in marketing, small average size of holdings, difficulty in purchasing and leasing land, low yields, low level of technology and a non-transparent subsidy system in which measures of agrarian policy often mask market signals.

Although the poor level of technical equipment is a problem in some sub-sectors in agriculture, the bulk of the problems derive from the ineffectiveness of the market. The consequences of this kind of situation can be some extent be measured for each sub-sector by the indicator called DRC, domestic resource cost. Results show that the value of domestic resources in most agricultural products is greater than the value of the product itself, measured in world prices. This judgement needs to be taken very seriously, because the figures are the results of an analysis of the operations of successful farmers, while most Croatian agriculturalists operate much below this level.

Rural development and environmental protection

Croatia is a country with very valuable natural resources, primarily in terms of quality. The land is of fairly good fertility and is fairly unspoiled in European terms and, along with high quality water, forest and coastal zone resources, provides a good basis for the development of agriculture and fisheries, forestry and hunting and fishing-based tourism. The creators of the agrarian policy in Croatia are well

aware of these advantages, as well as of the facts that rural policy has to cover an area much broader than farming alone. The need to foster the quality of life in rural settings and at the same time to protect the rural environment must be incorporated into agrarian, or rather rural, policy. This point of view is in line with the changes of the CAP in the EU, which has considerably expanded beyond its initial framework of the early 1960s.

The most recent adjustments to agricultural policy stress the need to create both agricultural and non-agricultural employment opportunities in the rural areas as means to improve rural income. The creation of opportunities for non-agricultural employment would facilitate the improvement of the agricultural structure, freeing up agricultural resources for the sake of the consolidation of viable holdings. According to the opinions of experts[vi] this section of agrarian or rather rural policy is still to be bolstered by specific programmes. For the moment, no satisfactory alternative sources of employment in rural areas are being created, because the governmental policy is not creating an environment favourable to enterprise.

As against this, there is an attempt to underline the advantages of the current system of management in Croatian agriculture. In the European environment there is a lot of talk about an about turn from "scale-oriented agriculture" to "quality-oriented agriculture" (quality of food and environment). The way out of the current situation is seen in sustainable agriculture, harmless to the environment, which will leave unspoiled resources for future generations. This system of land use can supply the Croatian population with a sufficient supply of quality food, suitable both for the customers of tourism and for export.

The socio-economic aspects of agriculture

In the absence of alternative employment or income creation in the rural regions, Croatian agricultural policy is in fact a mixture of economic measures and social protection, the last being fairly important. In the regional incentive policy, although a certain advance has been made, there is still not enough system in the regional approach. The status of the family farm is still unsettled – the way, qua natural persons, that they do business creates restrictions for both the institutions and for the economy itself. With few exceptions, the former "publicly owned sector" in agriculture – the socialist agribusinesses – underwent, in the post-war years, because

of war damage and inappropriate models of transformation or privatisation, collapse, falls in productivity and employment and knew great difficulties in their operations.

In Croatia there is still very little development of the association and combination of farmers via coops and other forms such as contractual cooperation. Although the number of coops is relatively large, most farmers are outside these forms of business organisation. The institutional presentation of the business interests of agricultural producers is not functional enough or developed on the basis of partnership with the formal administrative departments. The services providing expertise set up to encourage progress in agriculture are not totally effective. The reasons for this state of affairs can be found in the insufficiency of high-quality expertise, poor level of equipment, and inadequately worked-out regulations.

Croatian agriculture and the EU[vii]

By way of beginning to the process of stabilisation and association, the EU adopted trade measures opening up its market to the countries of this region. This is an asymmetrical form of trade liberalisation aiming to increase the export capacities, ability to attract foreign investment, and political and economic stability in the countries of SEE. The regulation was applied on 1 November 2000 and will be in force until 2005. The trade regime for the area of food and agriculture products means duty free access for domestic producers to the EU market (except for *baby beef* products, for which customs duties have been cut considerably) and quotas for some sensitive EU products. On these quotas there are some sorts of fish and fish products, wine and *baby beef*, and the common quotas are applied on the *first-come first*-served principle.

In return for such preferences, the EU requires from the beneficiary countries the implementation of economic reforms and region-based cooperation. In talks concerning the signing of the SAA, Croatia sought the retention of the existing preferences with the possibility that they would be improved still further, and this was on the whole achieved. Croatia will accept the application of gradual liberalisation of imports of products originating in the EU during the transition period, not longer than five years, depending on the sensitivity of the given product. Talks are being held separately for agricultural products, for food products, for fish and wine.

The main issues referring to the adjustment of agricultural policy in the negotiating procedure with the EU also include direct payments to farmers and quotas for dairy products and sugar beet. It is expected that the new member countries will be able to use the measure of direct payments to give incentives to their farmers in the future too, but not to the same extent not to be found in current members.

Adjustment of agricultural legislation

Because of Croatia's entrance into the WTO, its imminent entry into CEFTA and, in the future, into the EU, it is essential to make some adjustments of Croatian agricultural legislation to the legislation of these economic groupings, particularly to that of the EU (the White Paper).

In Croatia, at the end of 1999, there were 14 laws, about 120 sets of regulations, a large number of decisions, orders, decrees, rules and announcement in force in the activities of agriculture, fishery and veterinary science. We will pick out the fundamental Agriculture Law (NN 66/01), the Agricultural Land Law (NN 66/01), the Ecological Production of Food and Agriculture Products (NN 12/01). A Food Law and a Genetically Modified Organisms Law are in preparation.

The general Agriculture Law governs the area of agriculture and the existing legislation and the functional connection with many areas that are not yet legislated for. When the Food Law is passed, together with the concomitant other byelaws adjusted to the requirements of the WTO on the principles of the *Codex of Good Agricultural Practice*, and the principles of the Cooperation Agreement with the EU and the WTO, the road towards settling the demands made by world and European integration will be made much easier.

Contemporary trends of ensuring quality and security of food have enforced the need to provide a legislative backing for ecological agriculture. The Ecological Production Law governs the ecological production, processing and sale of agricultural and food products, considered as essential factors in the protection of human health and life, consumer protection, conservation of nature and the environment.

In further adjustments, a more detailed analysis and comparison of every individual law with its key measures is required, with particular respect for the First Phase[viii] measures and the setting of priorities, while the economic situation and the development strategy are taken into consideration.

CONCLUSIONS AND RECOMMENDATIONS

In an analysis of domestic agriculture our starting point is the already mentioned limitations which are still holding back both the attainment of the aims set up by agrarian policy and the implementation of the measures for the Croatian agriculture development strategy. At the same time, the agriculture sector does have considerable developmental advantages, such as natural and regional potentials, which have not to date been taken advantage of as they might have been.

One of the strategic options in attaining the aims of the agricultural development policy is the endeavour to get the Republic of Croatia into the currents of world and European trade and economic integration: WTO and CEFTA membership have been attained, and, over the longer run, association and membership of the EU are expected. Unlike full membership, which implies full customs union, the removal of all mutual trade barriers, and joining the CAP, the effects of associated membership are very limited.[ix] That is, the gradual abolition of customs duties relates only to industrial products, while the liberalisation of farm and food products is controlled, and is based on mutual exchange of concessions, that is, partial reduction and abolition of customs duties, on the whole for less sensitive products, with the retention of quotas for preferential imports. It is expected, then, that the consequences of associate membership in the EU will not be as negative as Croatian farmers fear, and technical and consultative assistance in efforts to improve and develop agriculture can be expected. The SAA established the foundations for future cooperation in the agricultural and agribusiness sector, which will go to spur the modernisation and restructuring of domestic agriculture in line with EU standards. The fundamental principles of this cooperation are the encouragement of sustainable rural development and the development of forestry, and the harmonisation of veterinary and phytosanitary legislation with that of the EU.

Joining the EU can be achieved by total adoption of its entire legislation. Taking into account the time and resources needed for the harmonisation, it can be expected that the main challenge while adopting the legislation will be more in the way of the adjustment of the administrative structures and the society as a whole to the conditions necessary for the legislation to work than the adjustment of the wording of the laws. Croatia is only at the beginning of this process. The first steps have been taken in the adjustment of the legal, political and institutional measures, modelled on the CAP and the models that are

adopted by Slovenia, because of the common heritage from the previous political system. The newly proposed system of incentives in agriculture provides for special treatment for viable agricultural businesses that will be encouraged by models of market price policy and capital investment, while the uncompetitive farms will have to go into a system characterised by a structural policy (income support, pensions, aid to programmes of rural development). Structural policy measures will have to be used to stimulate the entry of the young into farming, to give expert reinforcement to and systematically organised the training of young farmers, to introduce incentives for investment in farms/production and for adjustment to market needs, for the reduction of energy costs, improvement of product quality, better conditions for the life and work of farmers and their families, and for the preservation of the environment and the biological diversity of the ecosystem. Monetary aid should be given to areas where it is more difficult to make a living in agriculture, such as the highland and mountain areas, the islands, the areas of depopulation. Also important is aid to combination and association, and mutual business link-ups of farmers with the activities that go alongside agriculture.

In the area of institutional support quite a lot has been done through the foundation of the agricultural consultation service, the market information system in agriculture, and the Agriculture Research Council.

Since agriculture is one of the more sensitive sectors, in both the EU and in Croatia, local regulations governing the development of agriculture should be harmonised with those of the CAP in order to attain a common end: increased competitiveness of agricultural producers and agricultural products. For this reason, for the state, that is, for the government and the line ministry, the question of how to create the conditions for the achievement of competition still remains.

The first analyses of possible scenarios for adjusting domestic agricultural policy to the demands of any future EU accession, or the consequences of trade liberalisation, do not reveal the need for any drastic changes in production, consumption or trade models; that is, the new economic environment will not in any essential way either increase or reduce the existing problems in the agricultural sector (*A quantitative analysis of the effects of Croatian agrarian trade policy on the agrarian and food sector*). A continuation of trade liberalisation via bilateral free trade agreements is recommended, particularly in the Balkan region, while encouragement of competitiveness in the agricultural sector, in line with the results of the research into the competitiveness of domestic agriculture, should be achieved through the following measures.

- Give teeth to the law about making contracts and encourage the respect for contractual conditions in business operations, without particular fears or privileges.
- Make the passing of agrarian policy decisions more transparent and encourage them to be implemented in practice; set up an appropriate system of criteria for the payment of aid to agriculture; bring in a simpler system of direct payments in agriculture, thus stimulating farm income, and at the same time making possible a more powerful and freer impact of market prices and a more profitable use of natural and agricultural resources.
- Adjust the customs system, which has already largely been done during the WTO accession process; further adjustment is necessary in order to reduce the costs of the protection of highly protected products for the sake of those products in which Croatia has comparative advantages.
- Put the agricultural land market in order, which would settle the question of collateral when loans are being made.
- Improve economic capacity at the level of the farm – through further investment in development services, encouragement of the research and educational system in agriculture.

The way to answers to which legal, political and institutional measures have to be taken and how they should be put into practice is still a long one. Through which instruments of economic and structural policy should one work on the income of agricultural producers, the protection of consumers, the development of the rural space and regional balance? Is it realistic to expect that the West European models of agricultural aid will result in the same kind of success for our agriculture as well, when it has had a very different line of development? How can the results be tested? Is not Croatian agriculture, after all, so particular that a special way needs to be found for the adjustment of it to the developed economies?

The only thing certain is that the Croatian institutions responsible for negotiations with and convergence of Croatia on the EU must be very well prepared for the performance of their assignments, which means that it is necessary to go on providing for the specialisation of domestic experts within the administrative departments for the well-grounded making of political decisions that are in harmony with EU practice.

[i] *The CAP existed in a certain form from the conference of the six original members in 1958 in Stresa. That is, Article 39 of the Treaty of Rome, by which the EEC, later EU, was founded, gives fairly unclear goals for the CAP. In more concrete form, this was carried out after the adoption of the First Mansholt Plan at the said Stresa conference. In 1962 the Council of Agriculture Ministers adopted a timetable of action for common intervention prices for domestic markets, and also input prices in the working of various variable import duties (Kay, 1998).*

[ii] *Source: http://www.ers.usda.gov/briefing/EuropeanUnion/policy_common.htm*

[iii] *According to the document Croatia in the 21st century, Food, Office for the Development Strategy of the Republic of Croatia, T. Žimbrek, leader of the food section.*

[iv] *These indicators are: 1. nominal protection rate, NPR; 2. effective protection rate, EPR; 3. production subsidy equivalent, PSE; 4. effective rate of assistance, ERA (more in franić, 1999).*

[v] *Republic of Croatia - Competitiveness in Agriculture and EU Accession.*

[vi] *"A Strategy for Croatian Agriculture", Competitiveness in Agriculture and EU Accession.*

[vii] *According to the document Croatia in the 21st century – Food.*

[viii] *First Phase measures are the key measures of the harmonisation of the legislation of an applicant country as stated in the White Paper, and they relate to operations of fundamental importance for other forms of supranational operations, such as the trade in goods and services.*

[ix] *Expected impact of associated membership in the EU on the economy of Croatia: a cost-benefit analysis. IMO, EIZ.*

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Chapter 8

ENERGY IN THE EUROPEAN UNION AND IN CROATIA

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ABSTRACT

The objective of this work is to determine the extent of the conformity of the Croatian energy sector with the conditions for membership in the EU. According to a comparative analysis an identification is made of the state of affairs in the energy sector in the EU, in the Republic of Croatia and in the applicant countries, the level at which the conditions for membership are fulfilled and the necessary measures that have to be implemented during the reform.

The main conclusion is that the legal system itself in the area of the Croatian energy system is already mainly harmonised with the EU system. However, concrete application of the rules departs from the way rules are applied in the EU. Since these rules obtain their final form only during application, and the manner of interpretation and application is much harder to change than the rules themselves, particular attention needs devoting to practice in the process of adjustment.

Key words:
energy, market liberalisation, single energy market, criteria for membership, Croatia, applicants, EU

** The views expressed herein are the standpoints of the author, are not binding upon the institution in which she works, and do not necessarily coincide with the official views of the Croatian Energy Regulatory Council (Croatian acronym: VRED)*

INTRODUCTION

Adaptation to the EU system is a process of the gradual acceptance of its rules and standards. The membership criteria define the necessary level of harmonisation with the EU system that must be attained by applicant states. In an evaluation of fulfilment of membership criteria, the European Commission takes into account the conformity of the national political system as a whole (degree of democracy, effectiveness of the rule of law, establishment of market economy) and of individual sectors.

In the energy sector, during membership negotiations the EU first of all required from the applicants an increased level of nuclear safety. However, with reform and liberalisation of the energy sector, new requirements have been set up for states that wish to join. In this paper, these requirements are identified, their implementation in the EU, in the applicant countries, and in the Republic of Croatia. According to what has been achieved to date by certain groups of countries, the main difficulties in meeting EU demands and the measures that might help to solve them are identified.

MEMBERSHIP CRITERIA

In each sector of the economy, fulfilment of the membership conditions is evaluated according to how much the economic and legal criteria for membership are met. The fulfilment of economic criteria for membership implies: a) the existence of a functioning market economy (liberalisation of prices and trade, demand and supply equilibrium established by market forces) and b) the capacity to cope with competitive pressure and market forces within the Union. The fulfilment of the second criterion is evaluated, however, among other things, according to an estimation of whether the proper infrastructure exists. The legal conditions imply the acceptance and application of the acquis communautaire.

At the level of states members and at the level of the Union no effective market economy in energy has yet been set up. For example, the system of market laws at EU level is only just developing (for more detail, see Pelkmans, 2001), and this is one of the elements for the estimation of whether there is an effective market economy. For this reason, in the energy sector the level to which membership conditions has

been fulfilled is monitored with respect to the degree of liberalisation achieved within the EU.

Hence, fulfilment of conditions for membership in the energy sector is estimated above all according to the ability to accept and apply the acquis. In this the key determinants for an estimation of the state of affairs are as follows:

- decide on an overall energy policy with clear timetables for restructuring the sector;
- prepare for the internal energy market (the Gas and Electricity directives; the Directive on electricity produced from renewable energy sources);
- improve energy networks in order to create a real European market;
- prepare for crisis situations, particularly through the constitution of 90 days of oil stocks;
- address the social, regional and environmental consequences of the restructuring of mines;
- waste less energy and increase the use of renewable energies such as wind, hydro, solar and biomass in their energy balance;
- ensure the safety of nuclear power plants in order for electricity to be produced according to a high level of nuclear safety;
- ensure that nuclear waste is handled in a responsible manner; and prepare for the implementation of Euratom Safeguards on nuclear materials.

CURRENT LEVEL OF FULFILMENT OF THE REQUIREMENTS FOR MEMBERSHIP

The current level of the fulfilment of membership conditions is evaluated according to a comparative analysis of energy in the Republic of Croatia, in the applicant countries and in the EU. Elements for an evaluation of the state of affairs are bounded on key definitions for the evaluation of the conformity of the applicants with the acquis and the results of previous negotiations (Lithuania team, 2002, op. cit., European Commission, DG TREN, 2002).[i]

Since during membership negotiations the capacity of an applicant to take part in the single market, adequacy of reserves and nuclear safety have been defined as key points, the analysis is focused on these determinants.

Joining the single market

The ability to take part in the single market is evaluated according to the institutional and technical capacities of a given country. Institutional capacity implies the acceptance and implementation of that part of the acquis that makes possible the establishment of a market economy in energy and technical readiness assumes an appropriate infrastructure and interoperability of systems.

Institutional capacity

The creation of a single market in energy and of the corresponding acquis started with the liberalisation of the 1990s. In the first phase, transparent pricing was assured, and the access of third parties to the transport infrastructure was made possible. The second phase of liberalisation started in 1993. This made possible the allotment of licenses for the construction of transport capacities on a non-discriminatory basis, which thus enabled competition. Vertically integrated firms separated the accounts of individual activities (generation, transmission, distribution) and the approach of third parties to the greatest consumers of electricity and gas was made possible.

In the third phase, which started in 1996, common rules for the electricity market were adopted (Directive 96/92) and for gas (Directive 98/30), and the preconditions for the free moment of electricity and gas in the area of the Union were created. The progressive opening up of the national markets started in 1999 for electricity, when a minimum of 26% of the total annual consumption was opened up to foreign suppliers. In 2000 the opening of the gas market started, when 20% of consumption was opened. The market opening plan anticipated that in 2003 33% of the electricity market should be liberalised, after which, by 2006, there should be a further consideration of market opening. For gas, 28% of the market should be opened in a period of five and 33% in a period of 20 years.

However, the European Council at its Lisbon summit (23-24 March, 2000) required gradual and total opening of the energy market. For this reason the European Commission in March 2001 proposed amendments to the directives for electricity and gas (96/92 and 98/30) and the regulation on the conditions for access to the electricity network

(for more see: European Commission, 2001; 2; European Commission 2001; 3; European Commission 2001; 4). Since for the adoption of these decisions the co-decision procedure process is applied, after the amendment by the European Parliament, the opinion of the Economic and Social Committee was obtained, and the acceptance of the directive by the Council, in June 2002 the European Commission published an amended proposal to the directive and the regulation (for more, see European Commission 2002; 1; European Commission 2002; 2).

The proposals allow for the opening of national markets to electricity and gas by 2005, the supply of all consumers and the creation of a single energy market instead of 15 open national markets. The opening of the market means that in 2005 consumers will be able to choose which supplier of electricity and gas they want. In order to strengthen competition and the creation of a single market, access to transmission and distribution networks will have to be assured without discrimination. In turn, in order to achieve this goal it is necessary for the network to be managed by an independent body, completely detached from generation and sales; that the national regulatory body, which has to be set up in all member states, determine, publish and approve charges for access to the network before they come into force. At the same time, the demand on the infrastructure is made that says the capacity of the transmission network to neighbouring countries must attain at least 10% of domestic generation.

Although these proposals have not yet been adopted and are not applied in the EU, they could be looked upon as conditions for membership. For the European Commission (2001) in the latest Regular Reports on Candidates' Progress towards Accession specifically states that during the implementation of reforms in the energy sector, adjustments must be carried out in such a way as to take into consideration the acquis that is in the making. A similar provision is placed alongside the explanation of the amended proposal for the Directive and the regulation (European Commission, 2002), in which it is said that the new Directive and Regulation will be binding upon all new members, and that exceptions will be able to be approved only during the transitional period in justified cases. Heads of states and governments of EU members at the Barcelona Summit (March 2002) accepted the liberalisation plan and requested the European Parliament and Council to accept appropriate instruments as soon as possible, i.e., during 2002.

The fulfilment of obligations and implementation of the directives about liberalisation of the energy market in member states is monitored by the European Commission.[ii] All the states in the area of electricity have liberalised their markets more than Directive 98/92 requires. In the area of the establishment of a single market for gas, progress is more tardy. First of all, Finland, Portugal and Greece have been given a transitional period until 2008, while France and Germany have not adopted the appropriate legal instruments.

The main obstacles in the way of the liberalisation of the market (in the sense of limiting access to the market) are the same in both sectors. They are insufficient regulator power/delays, inadequate unbundling, high network tariffs, balancing regime, dominant incumbents, cross border issues.[iii]

The applicants mainly successfully accept the basic principles of the EU system: transparency of market conditions and prices, guaranteed freedom of exchange of energy in the internal market and the opening of the electricity and gas market. For this reason negotiations about energy have been completed rapidly in all the applicant countries, except in Bulgaria and Romania, which, in the judgement of the Commission, will not be able to be included in the first round of EU enlargement. Nevertheless, the adoption and application of EU legislation in some applicant states is creating difficulties, and they have sought an extended transition period. The Czech Republic has been allowed to put the gas directive into action by the end of 2004, and Estonia that for electricity by 2008.

In the Republic of Croatia the EU principles have been formally accepted, while the bases for harmonisation with the EU system, including the most recent proposals for market liberalisation, were created by the package of energy laws of July 2001 (the Energy Law, the Law on the Electricity Market the Law on the Gas Market, the Law on the Oil and Oil Derivatives Market , the Law on the Regulation of Energy Activities (NN 68/01 and NN 109/91). These laws allow for the achievement of the preconditions that the Commission considers essential for market liberalisation: first, an independent regulatory body is formed; second, vertically integrated undertakings have to unbundle by 1 July 2002, and separate organisation of market and operation of the system from sales and production by 1 January 2002; thirdly, a transparent manner of defining transmission fee has to be defined in line with EU principles.

However, the laws only theoretically enable implementation of EU principles.

First of all, the Croatian Energy Regulatory Council (below: the Regulatory Council) is only formally independent. The Law on Regulation of Energy Activities (NN 68/01) explicitly states that the Regulatory Council is an independent legal entity (Art. 1). It also defines the criteria that should prevent any conflict of interests among members of the Council: they must not be government officials, must not have duties in the bodies of the political parties, may not be employed or perform any other business in the legal entities to which the Law on the Regulation of Energy Activities applies, may not be owners, joint owners or members of the managements or competent boards, nor may they perform any jobs that might lead to conflict of interests (Article 3 Paragraph 3). At the same time, the same law says that the term of office of members of the Regulatory Council should be five years, thus reducing the political pressure on their work (cf. Petrović, 2002; 66). However, the Regulatory Council cannot choose its own staff, rather the government of Croatia defines an institution (a non-profit making legal entity) which will prepare for the Council proposals for instruments and carry out other technical matters. The Council on the other hand has to finance the work of this institution (Articles 8 and 9 of the Law the on Regulation of Energy Activities). The government of the Republic of Croatia has stipulated that the Hrvoje Pozar Energy Institute (EIHP) shall be the non-profit making legal entity to carry out technical affairs for the Council (Vlada RH, Session 155, June 2002). However, EIHP is not a non-profit making legal person, rather a limited liability company. At the same time, the objective of the company is to carry out business for the Regulatory Council, but also, and among other things, for legal entities in the area of energy. Hence, one of the actual aims of the technical institution that prepares the decisions of the Council is the performance of matters that, with respect to members of the Council, are considered conflicts of interest. What is more, EIHP employees are also members of the managements and Supervisory Boards of INA and HEP, i.e., perform duties that with respect to members of the Council are considered conflicts of interest. Finally, through an amendment to the Law on the Regulation of Energy Activities (NN 109/01) the first period of office of the members of the Council has been cut from five to two years. The period of office of the first members runs out in December 2003, that is, immediately before the regular expiry of the period of office of the current government of the Republic of Croatia, which thus increases the exposure of members of the Council to political pressures.

Secondly, the vertically integrated concerns should have unbundled up by 1 July 2002. In the area of electricity this first of all means separating the generating, transmission and distribution firms, i.e., electricity supply, and the separation of the operation of the electricity system from generation and sales. Although the companies of the HEP group were founded within the statutory period, the unbundling did not take place. That is, the new tariff system (NN 101/02) does not define the prices of individual activities, which makes the independence of the separate firms that are part of the HEP group impossible. Hence it is still possible to shift resources from one activity to the other or to subsidise activities. In addition, in line with the Law on Electricity Market, a system operator has to be founded, independent of the generation and sales, and a market operator. A solution has been selected however in which the operator of the system and the operator of the market are the same legal entity. The system operator may not trade in electricity (Article 19 Paragraph 2 Electricity Market Law), while the market operator is responsible for the organisation of the electricity market (Article 21 Paragraph 1) and for collecting and selecting electricity tenders. The same legal person, then, has been assigned two assignments that are mutually contradictory.

Finally, the failure to define the transmission fee made the development of the market impossible. Formally speaking, privileged consumers have the right to choose their electricity supplier. However, they cannot put this right into practice, because there are no network rules that define conditions of access to the network nor the prices of the service of transmission.

In the area of gas, the division has been carried out more effectively. According to the Law on the Gas Market, transport is separated from production and supply. In January 2002 a gas transport firm, Plinacro d.o.o. was founded, and in March ownership of Plinacro was transferred from INA to the government of the Republic of Croatia. Plinacro should enable suppliers and privileged consumers access to the network on the principle of negotiated access (Article 8, Gas Market Law).

Third party access is made impossible by the delay in the passing of the byelaws, and to a lesser extent by certainly statutory provisions. First of all, the grid codes that define conditions of access to the network have not been defined for either gas or electricity. In the area of electricity, as has already been stated, the transmission fee has not been defined. Secondly, the third party usually gets into the market

through the construction of its own generating capacities so as to be able to satisfy the needs of the large or preferred consumers. In order to carry out this activity, the energy firm first of all has to obtain a license. The basic conditions to obtain a license are set out in the Energy Law (Article 17, Paragraph 1) and foresee, among other things, that an energy firm must employ a necessary number of professionally qualified employees for the performance of these jobs. These conditions also apply to the construction of new capacities. Thus, a new generating company must even before the beginning of construction employ a certain number of employees who will perform the activity only when the construction is concluded. New firms are thus discriminated against with respect to current firms, i.e., additional costs are forced up on them. Third, in the area of electricity, the Law on the Electricity Market, in its transitional and final provisions (Article 29), ensures the monopoly of HEP in the performance of public services without any time or any other kind of limit. Finally, the government of the Republic of Croatia and the Minister of the Economy should by March 2002[iv] have adopted the appropriate byelaws to make possible the implementation of the law (e.g., the programme for the implementation of the Energy Development Strategy, conditions for issuing licenses for undertaking energy activities, the General Conditions for the supply of energy). These regulations have not been adopted.

Nor have measures enabling the implementation of international obligations identified in the government's Integration Activities Plan of 1999. This refers primarily to the implementation of the obligations accepted in the Kyoto Protocol and the European Energy Charter Treaty.[v]

Technical capacity

For the application of the energy *acquis* and for access to a single energy market the appropriate infrastructure is also necessary. The basic energy infrastructure is made up of the oil and gas and the electrical systems. Linking the systems together is necessary for the accomplishment of the single market, the creation of new jobs and the preservation of the competitiveness of the economy.

Building up and linking together the energy infrastructure in the EU are regulated by the policy of the Trans-European energy networks (TEN-E) and the regulation concerning informing the Commission about investments of common interest in the energy sector (Council Regulation European Commission 736/96, 22 April 1996).

Seventy four projects were identified as being of common interest, and 18 billion euros were required for their implementation. Among the priority projects was the construction of connections between the systems of various members (e.g., electricity connections between Italy and Greece with submarine cables), the development of the system in some members (for example, the gas systems in Greece and Portugal), as well as interconnections with third party states (including the applicant states, the former Soviet Union and the states of the Western Balkans). In line with the conclusions of the European Council of Barcelona (March 2002), member states should by 2005 construct electricity interconnectons with neighbouring countries that reach at least 10% of their installed productive capacities.[vi] The investments required have to be covered by the energy undertakings.

From the point of view of meeting conditions for membership, applicants must link up with the EU interoperable system, primarily for the sake of securing supply. After CENTREL (the electricity network that links the Czech Republic, Poland, Slovakia and Hungary) was linked in 1995 with UCPTE (the net that covers the states of western Europe, the former Yugoslavia and Albania) the basic demand of the EU was the improvement of connections with member states. In meeting this condition applicant states make use of assistance from the PHARE programme. In 2000, this assistance programme was redefined, and from a programme for consolidating democracy, it became a pre-accession programme, and 60% of its funds are meant for the development of the infrastructure, including the energy infrastructure.

In the Republic of Croatia, the reconstruction (war damage is estimated at 37.3 billion kuna) and modernisation of the energy infrastructure are required, as well as the construction of new infrastructure. However, the Energy Development Strategy has not identified the infrastructure needs, nor is the infrastructure given as a condition for the implementation of an energy strategy[vii], and the government was charged with drawing up programmes and plans for the development, maintenance and employment of energy facilities (Energy Development Strategy, NN 38/02). Financing of the development was supposed to be provided by the pricing policy, and for public services via the tariff system. The Energy Law (Article 26 Paragraph 3) and the Law on the Gas Market (Article 7 Paragraph 2) stipulate that the tariff systems should be founded, among other things, on justified costs of development that have to be approved by the Ministry of the Economy. However, the government of the Republic of Croatia in ses-

sion on 22 August 2002 approved a tariff system for the transport of gas the justification of which is grounded on, among other things, the development plan. At the moment the tariff system was adopted the Economy Ministry had not yet approved the development plan. The government only had information about the drawing up of the plan for the development, build up and modernisation of the gas transport system in the Republic of Croatia from 2002 to 2011 on the agenda at a session a week later, i.e., on 29 August 2002. Similarly, the new tariff system in the area of electricity, since it does not split the price according to activities (generation, transport, distribution, auxiliary services, operating the system) does not enable the monitoring the use of the resources gathered meant for construction per activities.

Preparations for emergency situations

The EU requires the existence of a 90 day reserve of oil products (Directive 68/414/EEC and amendments to it), as determined according to the annual daily consumption of the calendar year. In states that for producers of oil themselves, the necessary reserves can be reduced by 25%.

Meeting this requirement creates difficulties for the applicant states, because it entails considerable investments in storage capacities. Hence during the negotiations they sought a transitional period for meeting this condition. Estonia, Latvia and Lithuania must construct the necessary storage capacities by 2009, Poland and Slovakia by 2008 and the Czech Republic and Slovenia by 2005.

Storage capacities in the Republic of Croatia can provide for consumption for 35 days. Domestic production covers the needs for 20-day storage, and hence to meet EU conditions, capacities that provide 35-day consumption need to be constructed. The estimated cost of this investment comes to about 200 million USD (Aron, 2002).

Apart from these capacities, it is necessary to provide capacities for the creation and renewal of operative reserves of energy. The Law on Oil and Oil Derivatives Market prescribe the maintenance of operational reserves in quantities equivalent to 15 days of average requirements in the previous year, and the manner and conditions of determining, using and renewing the operative reserves have to be prescribed by the Minister of the Economy.[viii]

Nuclear safety

In the context of its enlargement, the EU has stressed the importance of nuclear safety. In June 2001, the Council of the EU accepted a Nuclear Safety Report in the Context of the Enlargement. This report contains recommendations to applicants about increasing their nuclear security, the implementation of national programmes for improving nuclear safety, including the management of radioactive waste, spent fuel and research reactor safety. Particular attention is devoted during negotiations to the increased security of nuclear power plants and the management of nuclear waste. The safety of nuclear plants and the need for modernisation in Lithuania, Slovakia and Bulgaria (the Ignalina, Bohunice-V, Kozluduy plants) were priorities in the negotiations with these states. The EU encourages the enhancement of nuclear safety by co-financing the closure of nuclear units that cannot be modernised as well as affording technical and other assistance for the modernisation of nuclear power plants when this is possible from PHARE programme funds, EBRD loans and by contributions to the nuclear energy account managed by the EBRD.

For the Republic of Croatia, the question of nuclear safety is linked with the Krško nuclear power plant. During negotiations with Slovenia, the Commission determined that Krško meets the safety standards of the EU. However, in line with the Nuclear Safety Report in the Context of Enlargement, seismic testing and the adoption of a national programme for emergency situations are required.

Knowing that Slovenia is in the group of most advanced applicants, it can be expected that the Republic of Croatia will negotiate about membership when Slovenia is already a member state. Hence, unsettled matters in connection with Krško, especially those to do with the management of waste and the closure of the station, will have to be settled in line with EU regulations that, as soon as Slovenia becomes a member, will be obligatory and applicable to Krško power station. This relates primarily to the rules of transfer and storage of radioactive waste (Directive 92/3/Euratom, Regulation 1493/93).

Other elements

Other elements that the EU takes into consideration while evaluating the level of fulfilment of conditions for membership relate to

energy policy, the development of associated measures for the solution of the social, regional and ecological impacts of reforms and the implementation of measures for increasing efficiency.

In the area of energy policy, which is in the EU defined in the Green Paper on the Security of Energy Supply (European Commission, 2000), the main demand that is made on applicants is to adopt a policy with clear deadlines. In the applicant states, the annual plan for the implementation of appropriate measures is defined by the accession partnership, and the application of the acquis is facilitated by involvement in EU programmes (such as SAVE II).

Croatia has adopted its Energy Development Strategy (Official Gazette 38/02, available on the Web, www.hrvatska21.hr) the basic goals of which are increase of efficiency, diversification of sources, support to the development of renewable sources, increased security of supply, development of a better pricing policy and ensuring environmental protection adjusted to EU goals. The main objectives of the EU energy policy are security of supply for all consumers at acceptable prices, environmental conservation and the promotion of competition on the European energy market. The key measures for the fulfilment of these objectives are diversification of sources, implementation of the Kyoto Protocol and the creation of a single energy market.

However, although some of the necessary measures are identified in the Strategy, no timetable and no dates for their implementation have been defined. The energy law package has defined only the deadlines for the implementation of the first phase of reform of the energy sector, and these deadlines have not been met.

At the same time, energy sector reform policy in the applicant states, in line with EU requirements, ought to contain a plan for the solution of the social, regional and ecological consequences of the restructuring of the sector, and these matters have not even been considered by the Energy Development Strategy.

The use of renewable sources is a key factor in supply security and the fight against climate change. It is promoted by implementation of the Altener programme, and member states of the EU are bound to greater use of renewable sources by the Directive of the Council of the EU and Parliament about the promotion of the production of electricity from renewable sources (September 2001). The objective of this Directive is to step up the share of "green" energy in the EU, from 14% in 1997 to 22% by 2010. Croatia, in which the share of green energy was 15.8% in 1999, is in this respect comparable to the EU (Vuk, Marušić, 2000).

The objectives and strategy for the implementation of energy policy foresee a growth in energy produced from renewable sources of 1.33 – 2.13 times, depending on the growth scenario. However, no concrete measures to achieve these aims are foreseen, instead it is stated: "Organised and systematic concern for renewal sources *will be carried out* in the Republic of Croatia according to the National Energy Programmes *launched in 1997 by the government of the Republic of Croatia*" (Energy Development Strategy, p. 120, italics added).

No manner of financing has been defined clearly, nor have the resources required been estimated. The strategy does, it is true, anticipate the establishment of an Environmental Protection and Energy Efficiency Fund. However, although the draft law has been put forward, it is not clear how this fund would be financed. Various sources are mentioned, including commercial loans, interest on loans given by the Fund, foreign sources, the Budget, part of the price of given fuels and so on, without any indication of which parts would be financed in which way and in which ratios. Also predicted is the possibility for the redirection of resources from the profitable to the unprofitable part of the fund, without any rules and authorities being defined.

PERSPECTIVES AND CHALLENGES OF INTEGRATION

The Croatian legal system is formally harmonised with the EU system. Conformity of the legal system is an essential condition for EU accession. However, the legal system of the EU is not made up only of rights and obligations that govern the mutual relations of states members of the EU but the rights and obligations that directly relate to the subjects in the member states, i.e., to legal and to natural entities. For this reason for adjustment with the legal system of the EU it is necessary to pass the regulations and byelaws that regulate particular areas in greater detail. What is more, since the legal rules come to life and obtain their final life only during application, an identical formulation of some rule does not necessarily mean it has the same meaning. Since not even the deadlines for the implementation of the energy law package are respected, nor the procedure for the adoption of the reform measures (for example, when

adopting the gas tariff rules), one of the basic principles of the reform is threatened, that is, transparency. For this reason I am of the opinion that the EU convergence process in the area of energy cannot be considered successful, for practice, the manner in which the legal rules are interpreted and ultimately applied, is developing in a way quite in contravention of the principles laid down by the EU.

However, Croatia is relatively advanced in comparison with the other states of the region, and the European Commission in its SAA Implementation Report says that Croatia has a potentially key role in the energy linkage of the region, particularly from the point of view of the development of regional energy links (physical infrastructure and market). One of the conditions for further association with the EU defined by the SAA is the development of cooperation among the states of the region. Since the SAA explicitly secures tightening of cooperation in the adoption and planning of energy policy, including modernisation of the infrastructure, security of supply, and reinforcement of efficiency, this form of cooperation with the EU should be used to overcome the initial difficulties in the reform of the sector. As part of the CARDS programme, the EU has earmarked 16 million euros for the development of the transportation and energy infrastructure in Croatia, BH, Macedonia, Yugoslavia and Albania for the period 2000-2006. The assistance is subject to the obligations deriving from the SAA being fulfilled, and any failure in this respect might put the necessary investment at risk. With increasing import dependence, lack of funds could well additionally damage the already vitiated competitiveness of the economy of the Republic of Croatia.

In its decision of June 2001, the government of the Republic of Croatia made possible the approach of the Republic of Croatia to the regional electricity market in SEE. Acceptance of this initiative necessarily involves the facilitation of the development of the regional market by 2006; customers should have the ability to choose suppliers by 2005, the network rules should be adopted by June 2003, and UCTE standards by 2003.

Accomplishment of this cooperation will make it possible to meet the regional cooperation obligation, which Croatia has bound itself to in the SAA as precondition for further rapprochement with the EU and acceptance of EU demands, thus making fulfilment of membership conditions possible.

CONCLUSION

In adjustments to EU membership conditions, as well as formal, real conformity with EU regulations is essential. Croatia has achieved a relatively high level of formal conformity with EU regulations, but implementation of these regulations is late.

Participation in regional initiatives can make a contribution to the fulfilment of the conditions for accession. For example, joining in a regional electricity market will make possible acceptance of EU rules by 2005, and the actual establishment of regional cooperation. Since regional cooperation is a prerequisite for further convergence on the EU, and adoption of the acquis is necessary for joining the EU, this form of regional cooperation can be considered a measure that facilitates integration into the EU. In addition, the possibility of financing regional projects makes modernisation of the infrastructure easier, which is also necessary before EU accession. However, assistance is conditional upon strict respect for deadlines and obligations undertaken. It is necessary, then, to work out concrete implementation plans, with deadlines and clear divisions of authority and responsibility.

Since the energy sector is state owned, and will, until EU accession, remain mainly state owned[ix], it is mainly state or governmental bodies that are charged with implementation of the reform. For this reason, for successful reform of the energy sector, a successful state administration is also required, i.e., it has to be reformed, or some of its authorities have to be transferred to independent bodies. From this point of view it is necessary clearly to define jurisdictions and procedural criteria. In line with the laws, part of the authority has been transferred from the state to the Energy Activities Regulation Council. However, the jurisdiction and rules of procedure, the definition of which the government and the Economy Ministry are primarily charged with, are still not defined, and the authorities of the Council are restricted. Thus the main challenge in the area of the reform of energy is an augmentation of the efficacy of the public administration.

Finally, the EU enlargement plan includes states neighbouring on the Republic of Croatia, and these states will have to implement EU regulations after accession. For this reason the acceptance and implementation of such regulations here is necessary not only for the sake of Croatia being able to join the EU, but also to make possible trade with the neighbouring states after the EU enlargement.

[i] *These elements derive from the classical Copenhagen criteria. A review of fulfilment for the energy sector of Croatia before the signing of the SAA and the launching of energy sector reforms is contained in: Republic of Croatia Government, Plan of integration activities of the Republic of Croatia, Zagreb, 1999, pp. 550-551.*

[ii] *Directives are a legal instrument to which it is hardest to adjust internal law. That is, they give the objective of the standardisation that is obligatory for a member state, but the state itself can select the appropriate method for the accomplishment of this objective within internal law. Sometimes the directives can give exhaustive instructions, but sometimes they hardly mention them at all.*

[iii] *The obstacles are put in order of importance, in line with the report of the European Commission "Completing the internal energy market" (European Commission, 2001;1).*

[iv] *That is, within a period of six months from the time the package of laws came into force, that is, up to 26 February 2002. In this paper, however, whenever there is mention of this period, March 2002 will be stated as the time.*

[v] *The implementation of these obligations is necessary for adjustment to the EU system as well. For example, the acceptance of the rules defined in Directive 94/22 OJ L 164, 30 June 1994 concerning the transparency of rules for the exploration and exploitation of hydrocarbons coincides with the rules about non-discrimination and national treatment that derive from the European Energy Charter Treaty. In accordance with EU regulations and the European Energy Charter Treaty, it is necessary to provide access to the infrastructure for transit.*

[vi] *At the moment, in the EU area, about 8% of domestic production is swapped. HEP considers its capacities confidential.*

[vii] *The proposal of the Energy Development Strategy of 1999 contained a review of the necessary infrastructure projects, covering the following: the gasification of the Republic of Croatia; the Italy-Pula-Karlovac-GEA transport system project; Zagreb-Karlovac; Zagreb-Kutina-Slavonski Brod-Donji Miholjac; Vrbovsko-Split; Benkovac-Zadar, and minor transport gas lines; increase of the gas storage capacities (Okoli/Bokšić); development of a distribution network; development of equipment and energy users at the consumers; revitalisation and construction of new secondary refinery capacities; linking JANAF with other international oil pipelines; development of small cogeneration facilities (up to 2030 with a capacity of 1TWh of electricity); bringing two gas-fired generating stations of 300 MW on line (up to 2010); bringing the hydroelectricity generating states of Lešće, Podsused, Drenje on line; construction of a transit and distribution electricity network.*

[viii] *The deadline for adopting these regulations ran out in March 2002, and at the moment (October 2002) the working text of a new law about commodity reserves is being agreed on.*

[ix] *The Law on privatisation of INA – Industrija Nafte d.d. (NN 32/02) foresees that the Republic of Croatia will retain at least 25% plus 1 share until Croatia is received into the EU, and the HEP d.d. Privatisation Law (NN 32/02) that the Republic of Croatia will retain ownership of 51% of the shares of HEP until Croatia joins the EU.*

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Chapter 9

UNEMPLOYMENT AND EMPLOYMENT IN THE REPUBLIC OF CROATIA

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ABSTRACT

The labour market has the most important role in determining the standard of living of citizens of the Republic of Croatia, but this labour market is characterised more by the aim of preserving existing employment than of creating new jobs. Unemployment is a burning topic, irrespective of the considerable differences in data about employment or unemployment in various official sources. The paper will detail EU activities connected with employment, analyse the labour market and measures for reducing unemployment in the Republic of Croatia, and propose some ways in which the labour market might be improved.

Key words:
employment, unemployment, labour relations, labour market, Republic of Croatia, EU

INTRODUCTORY REMARKS

It can be sensed intuitively that over the long run unemployment, the regulation of labour relations and the situation in the labour market will not create a very great obstacle for the Republic of Croatia to achieve convergence with and join the European Union. Croatia is a small country, and although there is a large number of unemployed people, this should not affect the trends in the EU labour market, while the geographical mobility of the unemployed is limited by language and cultural barriers. Still, trends in the labour market could well be short-term and medium-term hurdles to Croatia's joining the EU. The most important reason is to be found in the relatively high payouts for welfare policy in the broader sense of the word, payments which are mainly channelled towards the poor. While the number of clients for various kinds of welfare transfers is increasing, the amount available for each individual is diminishing appreciably. According to the World Bank *Study on Social Vulnerability and Welfare Study*, the unemployed in Croatia, along with inactive people, are the most affected by long-term poverty.[i]

In the Croatian labour market, and in the regulation of labour relations, much greater attention is devoted to maintaining existing jobs than to the creation of new employment opportunities. Legislative solutions and political figures in the Republic of Croatia are more inclined to extend *the lives* of unprofitable firms than to stimulate the creation of new and sound businesses. This persistent, and exaggerated, maintenance of current employment produces the diametrically opposite result from that desired, and the uncompetitiveness and inflexibility of the labour market have resulted in a reduction of the number of existing jobs, and at the same time restricted the space for new employment. Thus there is *a polarisation* of society into the relatively safe (though, with respect to the cost of living, underpaid) employed (*the insiders)* and the unemployed (*the outsiders*), a very considerable number of whom are long-term unemployed with very slight chances and likelihood of finding work. This shows a total failure to understand (or even to know) the trends to greater flexibility that mark both the global and the regional EU economy, in which the emphasis is not upon *saving jobs*, but on creating the conditions for *employability*.

THE EUROPEAN UNION AND EMPLOYMENT

When the EEC was set up in the 1950s, its most important goals were to create the conditions for the free movement of goods, services, capital and manpower. Although there was some tendency to bring the populations of the member countries closer together, the practical ambitions of the EEC were economic rather than social, and activities such as *equal opportunities* were believed to be an integral part of the free market system and economic competition. Nevertheless, over the years, the EEC, and later the EU, acquired increasingly extensive authorities in the determination of social policy and action. In this policy, employment and the reduction of unemployment formed an important component of a successful struggle against poverty and social exclusion. In the last two decades, the policy of employment has become an essential determinant of the production of synergy between economic and social developmental goals, and in the attainment of equality and the creation of the opportunities for total participation in civil rights. Much of this was contained in the Social Protocol of the Maastricht Treaty adopted in 1992. This document states the objectives to be attained, and includes the obviation of social exclusion on the labour market and in society as a whole, draws attention to the existence of discrimination in the labour market, the lack of opportunities for training and further training, inadequate protection of minorities, a lower level of social protection and restrictions on freedom of movement.

The condition of employment or the lack of it and the solutions for it vary from country to country within the EU. Esping-Andersen (1990) distinguishes three basic models of social policy, and hence of employment policies. The first is *the neoliberal*, in which the emphasis is on the effectiveness of the market, a restrictive assistance policy in which there is great social stratification (e.g., in the UK). The second is the *social-democratic*, in which there is little stratification, the public welfare system is very developed, the state provides direct protection or financially assists members of society at risk and attempts to improve their quality of life and enable them to participate fully in the labour market or to have security during times of unemployment (the Scandinavian countries, for example). The third is *the corporate model*, in which there is also high stratification, while government intervention is provided via market regulation or financial assistance (for example, France and Germany). There are considerable differences in unemployment rates from country to country, as well as of

unemployment structure, average length of unemployment and attitude to the unemployed, and it is hard to speak of any *average situation* in the EU. In principle, the countries that we have termed social-democratic and that are systematically carrying out an active employment policy (mostly via further training, retraining and professional qualifications for the unemployed, as well as joint financing of the difficult to employ) have lower rates of unemployment (at the end of the 90s, about 6% in Sweden and Denmark). The neoliberal group also has a low rate of unemployment (UK – 6%), while the corporate countries have on the whole a greater rate of unemployment (Germany and France from 9% to 12%). However, of all the EU member countries, traditionally the highest rate of unemployment obtains in a fourth group – the Mediterranean lands, and the unemployment rate at the end of the 90s in Italy, Spain and Greece was as high as 16%.

Monetary benefits and assistance during a time of unemployment, apart from providing material security for the unemployed, are also important labour market regulation mechanisms. The attitude towards them in the EU, from the point of view of their compass, length and amount, is fairly similar to the views about the active employment policy. In the corporate and Scandinavian, or social-democrat, countries, a large number of the unemployed receive monetary benefits (about two thirds in Germany and Denmark) that are relatively high, while in the neo-liberal and in the Mediterranean countries the coverage of the unemployed that receive monetary benefits is lower (from 20 to 30%), and the amounts of the benefits are considerably lower. Still, in all EU member countries, because of increased outlays for unemployed and the reduction of budgetary revenue, and belief that it will encourage the unemployed to be more active in looking for work, since the early 1990s the criteria for being able to claim benefits and assistance during unemployment have been toughened and the relative amounts of the benefits and the periods for which they can be claimed have been reduced.

To put into operation the strategy and measures for the encouragement of employment and economic development, in 1993 the *White Paper on Growth, Competitiveness and Employment* was brought out; in this, the challenges, difficulties and the ways in which they could be solved were clearly stated (*European Commission*, 1993). The EU aim was to spur economic growth based on creativity and productivity, and the implementation of a social or welfare policy acceptable to the member countries, thus improving social and economic cohesion. The

European Council helps and encourages members to improve their education and training, including measures of accelerating employability and narrowing the educational gap. The Council constantly stresses the need for the development of an active employment policy, which apart from reducing unemployment, also helps in the reintegration of the unemployed and the provision of equal opportunities for everyone. At the same time, the Council is aiming at the establishment of gender and age equality, the protection of those at risk and ethnic minorities, and a consistent and ongoing encouragement of social integration, under the motto that *employment is the best defence against poverty and social exclusion*.

Since about 1997, the EU has stepped up its activities aimed at reducing social exclusion, and the Amsterdam Treaty stressed the need for the creation of an advisory Employment Committee, while in the same year a decision was adopted about putting an appropriate strategy into force. In this, an increasingly greater stress should be placed on the creation of a system of social protection to stimulate employment and accelerate employability.

The European Employment Strategy is part of a broader political programme that the Union launched in 1997 in Luxembourg, and ratified in 2000 in Lisbon, with the purpose of creating an EU that would be the most dynamic and most competitive region in the world, founded upon knowledge, a sustainable environment friendly to economic growth, in order to induce greater employment and social cohesion. In the conditions of the creation of a common market and currency it is necessary to coordinate, adjust and approximate (though not to equate) social policies, in order to deepen the consensus and to make use of the experience of various different states. There was total acceptance of the viewpoint that employment and social protection had to work together for the purpose of reducing exclusion and stimulating integration via participation in the labour market. In its monitoring of unemployment and employment and social policy, the EU regularly collects and considers 18 indicators[ii] connected with the fight against poverty and social exclusion. The list of these indicators draws attention to the complexity and multidimensionality of poverty and constitutes a foundation for the consideration and working of national and international programmes and the construction of a poverty eradication policy.

The European Employment Strategy defines the framework of the employment programmes for member countries, which the coun-

tries make annual reports on. The member countries carry out and report on their employment and labour market policies to do with four groups of issues:

- *improving employability and quality of work* – with an emphasis on an active labour market policy, particularly oriented towards the young and the long-term unemployed;
- *the development of enterprise* – most of all through deregulation, the simplification of approaches to the market and the easier foundation of small firms;
- *encouraging the adaptability of firms and employees* in which an important active role is given to social partners;
- *the strengthening of the equal opportunities polic*y, focusing on the problem of employment and equal conditions of work for women and people with reduced capacities for work.

As for *employability and quality of work*, in the reporting process the emphasis is placed on the supply of work, while relatively little attention is devoted to the actual quality of jobs. A considerable advance has been made in improving knowledge and expertise, and in whole-life learning and professional development. Half the members have adopted whole-life learning strategies, but the implementation of them is still in the early phases. At the level of the EU and within members there is clearly lack of adequate coordination and synergy among various competent bodies (ministries, offices and agencies). Within the set *developing enterprise*, a great accent is placed on the simplification of administrative procedures and legal approaches that determine the creation and development of business units. In several countries there is increased activity aimed at suppressing unreported work, while at the same time there is an attempt (slow, if truth be told) to reduce the burden of taxes and social security contributions. In most countries, ongoing attempts are being made at simplifying the regulations concerned with hiring and firing, which are believed to be essential components of labour market flexibility. Other forms of flexibility relate to *flexible working time* and flexible forms of work. In many countries, the social partners are working very hard together to improve security and health at work, because as a whole the situation is not satisfactory. Surprisingly, most countries have not undertaken (or at least, have not informed the EU about) any very significant activities to achieve full computer literacy in society up to 2003. Some countries are a very fine

example of activity and innovative approaches to *gender equality in the world of work*, a better *synchronization of life and work*, and the reduction of diverse forms of discrimination (especially Denmark).

As a whole, the achievements of the *European Employment Strateg*y are very positive and encouraging. Today the results of the coordination of employment policies can be seen. Since 1997, more than 10 million jobs have been created, and the number of unemployed has been reduced by more than four million. Particularly much was achieved in 2000, when the EU saw an average increase of 3.3% in GDP, an increase of productivity of 1.6%, accompanied by the creation of three million new jobs, and a reduction of the rate of unemployment to 8.3% (corresponding to the level of the early 1990s). According to predictions of the rate of unemployment of those capable of working and of the employment of women in EU member countries, these should be 67 and 57% by 2005, and 70 and 60% by 2010. At the same time, valuable effects of structural reforms in the European labour market were seen, particularly greater employment in the high technology and scientific research sector, as well as improved entry of women into the labour market.

What remain of the essential structural weaknesses of the European labour market are the still high share of long-term unemployed (especially the young), considerable gender biases and low rates of unemployment for older workers. By 2010 the rate of employment for those in the 55 to 64 age group should be increased to 50%. Everything stated here is a sign that it is necessary to make use of the various mechanisms for achieving a lasting improvement in the labour market. Part of this, undoubtedly, is the active European employment and labour market policy, but this is not enough by itself. For this reason in the future the aim of the strategy should be the achievement of a synergy of active employment and labour market policies and coordination of macroeconomic policies. Employment and the condition in the labour market are of common interest, and in conditions of monetary union they cannot be left only to the member states.

Just as the employment/unemployment situation varies in the different EU member states, so there are considerable divergences among the countries that are in the first round for joining. In fact the differences are almost greater than the similarities. While one group of such countries had relatively low rates of unemployment in 2000 (Estonia, Czech Republic, Hungary 7 to 9%), a second group had very high rates of recorded unemployment (Bulgaria, Slovakia and Poland

15 to 18%). Slovenia, after a high recorded unemployment rate in the 1990s (around 15%), managed to cut this to around 12% in 2000 (Vidović, 2002). The unemployment rate alone is not an adequate indicator of the gravity of the situation in the labour market; rather, the structure of unemployed looking for work needs to be made clear. In this Poland is the best off – the long-term unemployed (those waiting for work for more than a year) were about 40% of total unemployed, while Slovenia was worst-off, with almost two thirds of the unemployed waiting for more than 11 months. The situations in Bulgaria and Latvia are only slightly better. It would seem that the existing situation in the labour markets – high and debilitating unemployment – is nevertheless not an insuperable barrier to entry into the EU, not even for large countries such as Poland and Romania; hence there is no reason to suppose that it should be for Croatia either.

As from its own members, the EU sets those countries in the first round (Poland, Czech Republic, Estonia, Hungary and Slovenia) the requirement to draw up *annual national employment programmes*, and reports on their implementation. At the same time, the EU does not impose any particular requirements on them for the transitional period in the sense of employment and hiring, but does seek additional information about social protection, labour legislation, equal opportunities for men and women and discrimination in hiring.

MOST IMPORTANT CHARACTERISTICS OF EMPLOYMENT AND UNEMPLOYMENT IN CROATIA

This part of the paper will consider features of the labour market in Croatia, particularly the working age population, rates of activity, trends and markers of employment, and the scope and structure of unemployment. In the ten year period under observation, from 1991 to 2001, the total population fell by 150,000 (3%), but the working age population increased by more than 500 thousand. Simultaneously, the activity rate (active in labour force / working age population) fell from 65.3% in 1991, to 50.7% in 2000. This reduction was mostly the consequence in a fall of the number of employed persons (by 285,000 or 14%), which was accompanied by a growth (absolutely and unexpectedly weaker) in the total number of unemployed persons (69,000). The greatest absolute fall in the number of employed was recorded in legal entities, irrespective of the form of ownership.

Table 1. The demographic structure of Croatia 1991-2001 (in thousands)

	1991[a]	2000[b]
Population as a whole	4,499	4,349
Working age population	3,125	3,647
Active	2,040	1,850
Employed	1,811	1,553
Unemployed	229	298
Inactive	1,711	1,797

Source:
[a] DZS(1993:78)
[b] DZS (2002:131)

Table 2. The active agricultural poulation, employees in legal entities of all proprietorial forms, in trades and freelance or selfemployed occupations[a] (in thousands)

Characteristic	1991	2000	Indices 1990=100
Active farm population	265	166	62
Total employed	1,432	1,258	88
In legal entities of all forms of ownership	1,303	1,053	81
In trades and freelance or self-employed occupations	129	205	160
Unemployed[b]	254	357	140

Source:
[a] DZS (2002:115)
[b] DZS (2002:11)

Table 3. Structure of the labour force according to qualification level

	Employed			Unemployed
	1981[a]	1986[b]	1996[c]	1996[c]
Total	100	100	100	100
Elementary school not completed	19	17	9	4
Elementary	21	20	21	19
Secondary[d]:	48	49	53	67
Colleges	5	6	7	4
Polytechnics, universites, academies	7	8	10	6

Sources and notes:
[a] RSIZ Usmjerenog obrazovanja, 1985.
[b] Republic bureau of Statistics (RBS, 1988. Dokumentacije 701 and 705, Popis radnika udruženog rada 1986.
[c] DZS (2002:128)
[d] For the sake of comparability betwen years, for 1986 the 1st and 2nd degree of "directed education" are assigned to elementary school, and 3, 4 and 5 to secondary school. For all years, schools for skilled and highly skilled workers and other secondary schools are luimped together as secondary schools.

However, divergent trends with total unemployment should be remarked: while the number of those employed in legal entities has fallen by practically a fifth, the number of those in trades and self-employed occupations has increased by almost three fifths. If we look at employment in legal entities not including the army and the police (which is the only definition of employment comparable over the whole period), the fall came cumulatively, as compared with the situation before the transition, to about 35%, with a recovery that is visible only at the end of the period under observation (Biondić et al., 2002).

In spite of the difficulties in employment, in the whole period after 1980, there has been a sustained and continued improvement in the qualifications and employment structure of those employed in Croatia. This is the consequence of the hiring of skilled younger people, as well as the further training and education of those already employed. Since changes are however best visible at longer intervals, we give some details about the labour force in 1981, 1986 and 1996 and, for comparison, data about the educational structure of the unemployed in 1996.

The educational and qualification level of the population and the employed are important factors in employment, the alleviation of poverty and social exclusion, and the attainment of economic development. In a relatively short period, the structure of the labour force according to level of formally acquired educational qualifications was much improved (of course, we do not go into the question of the real quality of given educational curricula and courses). While in 1981 almost half of the employees had not even finished elementary school, in 1996, there were less than a tenth of such people among the employed. The share of the employed who had completed secondary school, which at the beginning of the 1980s was less than 50% of all employed persons, in 1996 was more than a half of all employees. There was a particularly considerable rise in the share of persons with some form of tertiary level education, which increased by almost a half (from 12% in 1981 to 17% in 1996). On the basis of development to date, of the further education of the population and the employees, registered vacancies[iii] (jobs available as reported) and of the educational structure of employees in developed countries, we may expect a further decline in the number of employees who have not completed elementary education, a stagnation in the number of employees with junior college level tertiary education, a slight rise in persons with degrees and a considerable increase in the number of persons who have completed secondary education in the employed category. In comparison with the employed, in the educa-

tional structure of the unemployed there is a higher percentage of persons with secondary education, and a considerably smaller percentage of those with some level of tertiary education, which is actually in contradiction of the widely held opinion that the educational structure of the unemployed is better than that of the employed. Educational level is a really essential determinant of employability. Apart from needs for employees with tertiary education being greater than their percentage in total current employment, unemployed persons with this level of education wait for a job on average a shorter time.

Unemployment in Croatia is mainly structural in nature; i.e., it is the consequence of maladjustment between supply of and demand for labour with respect to the occupations, education, knowledge and skills of job seekers and the requirements of existing jobs. The dynamics of transition from employment, unemployment and inactivity are very weak. When someone has once lost a job, the chances of reemployment are slight. This is exacerbated by the inappropriate education and qualification structure of the unemployed, that is, their failure to have the knowledge and expertise being sought and limited opportunities for relocating to areas where there are certain possibilities of employment. In addition, there are other labour market restrictions conditioned by the relatively small difference (and certainty of reception of) the lowest wages and the various benefits in the welfare system (which does not provide adequate stimulus to active job-seeking), a highly developed underground economy and psychological barriers (such as indecisiveness and incapacity for employment because of long-term unemployment and lack of preparedness for education, the acceptance and application of new knowledge). In addition, labour in the Republic of Croatia is expensive because there are few who pay taxes and contributions, and a large number of beneficiaries of various forms of welfare transfers.

There are two sources of indicators of employment and unemployment in Croatia. Firstly, there are the data about registered unemployment processed by the Croatian Employment Service (CES). The other indicators derive from the LFS (Labour Force Survey), which has been carried out each year since 1996 by the CBS [Central Bureau of Statistics], the methodology of which has been brought into line with the rules and instructions of the ILO and Eurostat, comparability with research in EU countries thus being assured.

According to CES figures, in the given period, from 1991 to 2000, the number of unemployed increased by more than 100,000 or

about 41%. A particularly high rise was recorded in 1991 (almost 60%), when the number of unemployed reached the level of 254,000. A certain revival of economic activities in the second half of the nineties (GDP rose in 1996 by 6% and in 1997 by as much as 6.5%) was not accompanied by increased and more rapid hiring; instead, the number of unemployed went on rising considerably. Average registered unemployment in 2000 was 358,000. After a great fall in the number of reported vacancies (which in some years of the 1980s came to more than 230,000[iv], and during the 1990s no more than 130,000, with the lowest level being attained in 1991 – about 79,000) in 2001 a considerable rise in the number of reported vacancies was recorded, and it came to 203,000. The increase in the number of available vacancies did not lead to a reduction in the number of unemployed (the number had grown to 395,000 by the end of 2001), but the rise in the growth of unemployment was slowed down; thus the annual rise of 11% seen in 2000 was almost halved in 2001, when it came to 6%.

Table 4. The most important labour market indicators in Croatia

Indicator	1996	1997	1998	1999	2000	2001
LFS rate of unemployment[a]	10.0	9.5	10.5	9.9	9.5	10.4
men	11.4	10.9	12.0	13.6	12.8	
women	14.5	16.1	15.0	17.3	16.3	
Rate of registered unemployment[a]	15.7	16.5	17.7	19.5	21.3	22.0
Employment rate[b]	50.6	58.7	43.5	49.3	56.9	42.7
men	47.0	54.5	40.6	44.8	51.7	
women	38.9	42.6	49.7	36.4	41.8	
Share in total unemployment						
men	49.9	50.1	49.2	50.8	47.5	52.5
women	47.3	52.7	47.0	53.0	45.7	54.3
Rise in registered unemployment	8.5	6.4	3.6	11.9	11.2	6.2
Percentage of long-term unemployed[c]	51.3	49.0	50.4	50.3	52.5	52.9

Source and notes:
[a] For 1999. i 2000. the average of the half yearly rates.
[b] DZS(2002:131)
[c] Longer than a year.

The number of unemployed according to ILO criteria is lower than the number of registered unemployed, because the criteria are more stringent than those for the monitoring of registered employment. Hence this research shows a considerably larger number of employed and a smaller number of unemployed. For this reason there is a difference in the rate of unemployment in these two sources of more than 5%, unemployment in 2000 according to the CES coming to 21% and according to the LFS to 16%. According to civil service records, more than a fifth of the active population was unemployed, while the LFS suggests a smaller problem, because the average number of unemployed in this system of measurement was smaller by almost 80,000.[v] Approximately since the beginning of 1999, the differences between registered unemployment and the figures from the LFS have been shrinking, since unemployment according to ILO criteria has been rising dynamically. The LFS unemployment level of 16% is not unusual in the transitional countries. The highest rates of unemployment have been recorded in Slovakia and Bulgaria, 19%, while in Poland the rate came to 17%.

Not only is there a high level, but unemployment in the Republic of Croatia is characterised by an average long period of waiting for employment. Half of the unemployed wait for a job for more than a year, and as many as about 30% are unemployed for longer than two years. While in 1991 9% of the unemployed waited for more than three years, in 2000, on average more than a fifth of all unemployed waited this long for a job. More than half of the unemployed in the Republic of Croatia waited over a year for a job.

Important features of the alleviation of poverty during periods of unemployment are the existence, duration and amount of benefits and other rights for the unemployed, which the EU has clearly made a condition for future and current member countries. Article 57 of the Constitution of the Republic of Croatia clearly guarantees material security during unemployment, and the conditions for being able to claim it are laid down in the Law on Mediation in Employment and Entitlements during the Unemployment Period (NN 32/02). Material security consists of the right to financial benefit and assistance, rights to reimbursement of costs during training, the right to travel and moving costs, and the right to health and pensions insurance. The unemployed can also claim other rights, such as social assistance (maintenance assistance, housing costs assistance, various one-off forms of assistance); exemption from the payment of participation in health care; child benefit; tax relief; exemption from payment of court fees; extended pensions insur-

ance; rented housing; free school books and school meals; subsidy for part of the costs at kindergartens, and other things.

Although unemployment benefit is small in absolute terms (from 741.40 to 900 kuna p.m.) and does not last very long (from 78 to 312 days), which is shorter than the average in other countries, the amount given does have a ratio to the average salary similar to that obtaining in the developed industrial countries. We can say that the system of monetary benefits in the Republic of Croatia does provide its clients a certain protection, however limited by the capacities of the country, and at the same time does not create disincentives with respect to active job-seeking. If the amount of the benefit were much bigger, this would be likely to create negative motivation for job-seeking and thus promote the unemployment trap.

Irrespective of the considerable differences in the data about employment and unemployment, unemployment is a burning social and political topic in the Republic of Croatia; apart from there being a large number of unemployed, the long period people have to wait for a job is also a cause for concern.

MEASURES FOR REDUCING UNEMPLOYMENT IN CROATIA

At the beginning of 2002, the high level of unemployment led to the Croatian government launching its *Employment Stimulation Programme* (NN, 21/02). As a result of this programme, the Croatian Employment Service (CES) developed a series of active labour market measures, among which were: incentives for self-employment, loans for small and medium firms and public works. Some of the measures were directed towards speeding up the hiring of young and highly qualified persons with the co-financing of at least 60% of gross pay for the first year and an undefined period subsequently. At the same time, for any people with degree-level education taken on, an employer would receive a grant of 1,000 euros if the employment was extended for more than a year and became permanent. Such incentives are a considerable advance on the common bureaucratic provision of agency services in hiring, and mean a shift directed at users, and are better adjusted with the contemporary activities of the state such as giving monetary benefits, social services and regional development. Still, there is some uncertainty whether these measures for the hiring of the young

and the well educated are well targeted, for they do after all have above-average advantages in finding jobs.

As for other measures, one can mention the need to bring the *Programme for the Encouragement of Self-Employment* on stream, the aim of which is to bring unreported economic activities determined to be the main source of income for a considerable number of registered unemployed within the law. A special problem in Croatia is represented by unemployed persons over the age of 50 for, although it is true that they do not constitute a high proportion of total unemployed (14% as of May 2002), the number of them is increasing the most (up 20% in May 2002 as against the same month the previous year) and make up a considerable percentage of the long-term unemployed; for them, the systematic implementation and enforcing of the *By Experience to Profit* measures.[vi] Not only should older workers be integrated, but special attention needs to be directed to the employment of underrepresented groups: women and the disabled. It is true that the Labour Act does stipulate the protection of the more weakly represented gender, but the experience and attitude of social partners show that the existing regulation is inappropriate and does not produce any effects. At the same time, the integration of all categories of worker that are hard to activate on the labour market should be encouraged.

There have been many awkward or not properly adjusted approaches in social and labour legislation. Until the adoption of recent regulations (The Rights of Croatian Veterans of the Homeland War and Their Families Law, NN, 94/01), disabled veterans of the Homeland War had no incentive to work because a Croatian veteran as unemployed disabled person received 100% of the wage of active members of the armed forces. In this way, an employed invalid of the War had the same rights as those who were unemployed (Office for Social Partnership in the Republic of Croatia, 2002b).

Croatia has witnessed the phenomenon of the simultaneous rise in wages and a fall in the rate of employment (or a rise in unemployment), which is indirect evidence of the rigidity of the labour market. Such trends are characteristic of states in which the legislation provides a high degree of protection for the employed, thus making competition in the labour market impossible. The rigidity of the labour market can be seen in the long, complex and expensive system involved in dismissals (including the cancellation of the employment contract, the legally set notice period and amount of severance pay). This makes turnover in the labour force much more expensive, and the high level

of protection for employment reduces the flows in the labour market, and lengthens the average duration of employment[vii]. The reason for this is that the complex and expensive laying-off process means that the employer will not take on workers if he does not really believe that their work will be long-lasting and productive enough to cover the high costs incurred (Bertola et al., 2001). The result of this complex and expensive manner of firing workers, and the formality of registering newly-hired workers, is that employers, particularly those that fall into the category of small employers according to the Labour Law, will often not take on a replacement for a dismissed worker but rather make use of *black* workers. Also for the sake of making severance easier, most newly-employed workers (almost 80%) are taken on for fixed-time contracts, this kind of work thus becoming the rule and not the exception; it is used, without any control at all, in a way completely opposite to the intention of the regulations of the Labour Act, which is a further proof of the rigidity of the regulation of labour relationships. In addition, in connection with labour market rigidity, it is also worth mentioning problems related to claims of rights arising from labour relations, which is a result not only of the regulation of these relationships, but the problem of the clogged and inefficient judiciary.

In line with the *Programme for employment stimulation*, the Republic of Croatia is carrying out several active hiring policy measures while the rigidity of the labour legislation acts as a brake, tending to work against further employment.

POSSIBLE SOLUTIONS FOR THE IMPROVEMENT OF THE LABOUR MARKET IN CROATIA

Apart from on a better convergence of labour supply and demand, the focus should be on making labour relationships cheaper and more flexible, in order to increase the likelihood that more labour will be taken on. It is not necessary rashly and in a hit-or-miss manner to deregulate the employment and work relationships system, *rather to attempt to find the optimum ratio between the desired labour market flexibility and the required social protection*. Flexibility need not be thought up in such a way as to undermine the standards of labour law, but as an expansion of the far-reaching consequences of the regulatory matter of labour and social law. The point of making

employment relations cheaper and more flexible is seen in getting labour and social (establishing medical and retirement insurance) legislation to work in the same direction and in harmony, and in the procedures for the handling of labour conflicts.

For the sake of the improvement of employability and the reduction of unemployment in the Republic of Croatia, it is necessary to carry out *a review of the entirety of the labour and social legislation and make changes* wherever necessary. This implies *reconsidering all existing forms of contractual relations*[viii], which will not be an easy task. For while in the area of labour relations there is a fair amount of stability in the legislation, social insurance and social rights are very much subject to being politicised, and there are thus frequent amendments to laws and byelaws, and there is considerable resistance to the reduction of any social rights.

For the sake of reducing tax pressure, and the broadening of the tax base and the cheapening of labour – which are conditions for greater employment – *it is necessary to bring as many as possible of the economic activities of the working population within the limits of labour legislation*, and to carry out the legalisation of those activities of the grey or underground economy which should be brought within the fold of the law.

Activities related to professional orientation, whole-life education and qualification, professional development and the increase of the total stock of knowledge in society ought to be enhanced, and this will increase the adaptability of the labour force and make it more capable of adapting to the requirements of the labour market.

Active labour market policy measures must be more strongly directed to persons between 15 and 24, among whom the rates of unemployment are the highest (and in this group, the return from investment in human resources is probably the highest), with the emphasis on training and further qualifications. Training programmes should to the highest measure possible be matched with the demand for given occupations and capacities that will be sought in the future, that is, the emphasis should be placed on qualifying for a known employer.

The labour market *must be monitored all the time, and measures to ensure men and women equal opportunities and responsibilities undertaken*, in addition to measures to facilitate the position and return to the labour market of men and women who have family obligations.

At the micro-level of the company, for the sake of the improvement of productivity and the increase of employability, use should certainly be made of the potentials of the workers' representatives in the workers' councils, while at the macro-level the real possibilities of the agreements of the social partners need respecting. Collective negotiations and agreements of employers and workers' councils should be looked at within the context of sustainable economic growth, and not only as a means for protecting the interests of those currently employed. Long term planning of the activities of social partners could be brought in as a supplement to collective negotiations, in which the emphasis should increasingly be laid upon negotiating at the level of whole industries.

It is important *to redefine the system of the programme for looking after redundant labour*, which, supplementing the agreements of the social partners, would be ensured by the earlier involvement of the CES in the advisory process during the drawing up of the programmes for taking care of redundancies. This could be in line with the EC 98/59 guideline.

In the EU member countries, employment policy is determined and carried out in line with the European Employment Strategy and the annual regulations. The national *Programme for employment stimulation* should be supplemented in line with the market development policy, thus being brought into line with the national employment plans of the member states. The Croatian *Programme* should include all the indicators that the EU member states have accepted in the monitoring of the implementation and effectiveness of policy measures related to four groups of issues.

It is important *constantly to evaluate the effects and influences of the different measures* on the labour market. This implies determining improvements in the possibilities of employing people who have come out of educational programmes. It is also necessary to *consider the costs of obtaining these results*, or the cost effectiveness of given programmes. In the material law protection of the unemployed, it is necessary *to study the justification of extending and/or increasing the amount of the benefits* for unemployed people who accept retraining and professional qualification and the possibility of making one-off monetary grants for the sake of encouraging self-employment and so on.

Also needful is *the passing of a law concerning the professional rehabilitation and employment of persons with a disability* to prescribe the rights of such persons to professional rehabilitation, employment, setting

up activities, to regulate the measures for the encouragement of hiring and work, and to determine the foundation of establishments for professional rehabilitation, secure workshops and work centres.

CONCLUDING CONSIDERATIONS

U policy relating to reducing or eliminating social exclusion does not stop at hiring, but is directly linked to education and training systems, welfare, prevention of discrimination and other things. The working and effectiveness of this policy can, of course, be jeopardised if it comes into conflict with any desire for the preservation of national sovereignty, hence it is necessary to define quite clearly the scope and sphere of competence of the Union, particularly since a successful employment policy (and hence the struggle against exclusion) requires cooperation at all levels of government. This is the harder and more demanding in that the policy of employment and the battle against poverty and social exclusion do not as yet have in EU practice any clear conceptual definition, which is a barrier to giving shape to the immediate strategy.

The existing high unemployment will probably not be a major barrier to possible Croatian entry into the EU, rather, according to the experience of several countries (Eire and Portugal for example), integration into the EU, because of accelerated economic growth and development and the increased entry of foreign investors can be a very successful way of solving it. In employment policy, we could say that Croatia is on the whole moving in the direction of the policies that are being carried out in Europe. These policies are marked by a narrowing of rights through the implementation of more stringent conditions, and a stronger emphasis on active measures in the employment policy, with unemployment benefits being more linked to participation in training and re-qualification programmes. What remains is the rather fraught task of encouraging a more flexible labour legislation and the removal of organisational and administrative barriers to the foundation of new small and medium-sized enterprises, which should be of the most help in the mitigation of unemployment in Croatia. Within the context of Croatian association with and ultimate membership of the EU, constant attention is required to consideration of the labour market and labour legislation.

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[i] *The working age population (older than 15) can be divided into active an inactive. Active members of the population are those who are employed or who are seeking*

employment, or who have stopped working to serve in the armed forces or to serve a term of imprisonment. Inactive members of the population are those who are not employed and are not seeking work.

[ii] *Of these there are ten primary indicators, such as low income and long-term unemployment, and eight secondary indicators, which are used in the more detailed measurement and comparison of the member countries. The indicators cover four areas of social exclusion: financial poverty, employment, health and education.*

[iii] *According to data of the Croatian Employment Service, in requirements registered for employees in 1996, about 6% related to college level and 13% to degree level qualifications (CES, 2002: 155), while at the same time the percentage of them in total unemployment was markedly lower.*

[iv] *This might include jobs that were reoffered, if they were not filled within six months.*

[v] *Of the total number of registered unemployed, 136,000 of them (or 39%) do not meet ILO unemployment criteria because they are not available to work either for reasons of being inactive (59%) or not looking for jobs, because they did not wish to accept jobs offered or because they were working (41%), because in the LFS they announced they were working. It should also be said that among the unemployed found by the survey, 57,000 or 21% were not registered with the CES.*

[vi] *Joint financing leads to the hiring of older persons and endeavours to encourage employers to make use of the work experience they have acquired. The measures have been little employed in practice however and do not work from the point of view of raising the self-confidence and security of unemployed older persons; it does not give employers enough incentives to take on the older section of the working population (Office for Social Partnership in the Republic of Croatia, 2002a).*

[vii] *This effect can be positive for working people because it reduces the uncertainty of being employed. In addition, because of the greater links between employer and employee, employers are more apt to invest in human resources, which is also positive from a social point of view.*

[viii] *About permanent and short-time employment contracts, with full and reduced hours of work, overtime, constant seasonal and temporary work. As well as this, there should be changes in the provisions of the system of incapacity for work because the relatively large extent to which it is used has a negative effect on employers, especially small employers. This could be corrected by shifting the burden of compensating for wages to the Health Insurance Institute earlier on.*

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Chapter 10

CROATIAN ACCESSION TO THE EUROPEAN UNION: THE TRANSFORMATION OF THE LEGAL SYSTEM

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ABSTRACT

Croatian membership in the EU is subject to the fulfilment of the legal and political obligations laid down in, among other places, the SAA, the Stability and Association Agreement. The implementation of the SAA depends on the definition of its position in the constitutional system of the Republic of Croatia, including the ability for its provisions to be directly applied in EU and in Croatian courts, the legal status of the bodies provided for in the SAA, and the legal position and legal standing of the decisions taken by these bodies. The implementation of constitutional changes is necessary for full membership of the EU, and some changes are also necessary even for implementation of the SAA. These are provisions that provide the legal basis for membership in the EU, including the definition of the manner of making use of state sovereignty, provisions that define in detail the legal status of international law and European primary and secondary law in the internal legal system of the EU, and provisions that adapt the constitutional organisation of the Republic of Croatia to the conditions of associate or full membership of the EU, optimise the functions of the institutions of state authority that will have to work in new conditions. In an evaluation of the fulfilment of the conditions for membership in the

EU, the criterion for evaluation of the extent to which the legal system is adjusted will not be only the contents of the legal standards, but also the political, economic and social matters that are governed by these legal standards.

Key words:
international law, constitutional law, direct effect, sovereignty, legal interpretation, legal monism, legal dualism, division of power, courts, legal culture

INTRODUCTION AND METHODOLOGICAL REMARKS

It is an almost impossible task to make a diagnosis of the legal system of some country and compare it with the legal system of the EU. Looked at from a methodological point of view, such an effort is pointless, and could possibly be useful only as an exercise in comparative law. At the level of standards, the demands that the legal system of every potential member state must meet are quite clear. Applicant countries must unconditionally take on board the acquis communautaire, the legal patrimony, that is, the totality of all the legal standards of the legal system of the EU. Comparing any two legal systems, that of a given country and that of the EU, a meticulous investigator might without any doubt come to some knowledge about the similarities or differences in given legal rules, but the results of such a comparative approach would have extremely little to say about the capacity of the state the legal system of which is at issue to become a member of the EU. And how much the legal rules, both national and supranational, correspond to the social relationships that the applicant state would have to put in order is a completely different question.

A large number of the conditions that applicant states have to fulfil on the road to full integration into the EU are not to do with legal standards, but rather relate to economics and politics. Law, then, as discipline, is an instrument for accomplishing them. The characteristics of a legal system, the features of a legal culture and the substance of legal institutes can certainly help or harm the social and economic processes, but in and of themselves they are not criteria according to which it is possible to judge of the quality of a candidacy for EU membership.

For example, it is possible for the UK to fulfil the criteria for membership in spite of the fact that its legal system traditionally has no codex of fundamental rights and liberties, while some applicant country will still not meet these criteria, in spite of having comprehensive legislative regulation of this matter. From this example it should be clear that through no analysis of legal standards will we be able to determine the level of preparedness of a given country for EU membership, rather it is necessary to judge the extent to which criteria for membership are fulfilled in a material sense, a precondition for which is the distinction of the letter of the law and reality. Here it is necessary to make an important demarcation. Some of the fundamental requirements for the rule of law such as the principle of the division of powers, the democratic system, multi-party politics and the independence of the judiciary constitute the institutional context for a legal analysis and the regulation of the standards, and they have to be taken into consideration, staying all the way within legal methods. As, commenting on the distinction between the provisions of the law and the political, Harvard professor David Kennedy observed, American legal theory does not start with the founding fathers of the American Constitution, Madison, Hamilton and Jay, but with Oliver Wendell Holmes, who did not deal with the architecture of political but the analysis of legal institutes (Holmes: 1996-1997). Similarly, it could be said that the legal theory of the European Community did not start with the ideological founders of the EU such as Ernst B. Haas or Jean Monnet, but probably with Joseph Weiler, who was among the first to bring out the double aspect of supranationalist thinking, the purely legal and the political (Weiler, 1982).

The conceptual distinction of the regulatory and political aspects is relevant for the current analysis, the subject of which should be defined not only as an estimate of the harmonisation of the political institutions and/or legal standards of Croatian with the those of European law, but also as an analysis of the working of the legal standards in the political, social and economic context of rapprochement with the EU. Here it is of minor importance whether some Croatian legal institute governs a given relationship in law in the same way as or in a different way from that in the EU; the primary question is whether the given legal handling of a matter leads to real fulfilment of the criteria for membership. This does not mean that I think a comparison of the legal solutions and the fulfilment of the formal criteria are not relevant for a judgement of the adjustment of a national legal system to the European system. Precisely the opposite, the formal criteria in the law are often topographical signs on the way towards full mem-

bership, and without their fulfilment the process of convergence cannot possibly be continued. However, their fulfilment is only a necessary, and never a sufficient condition, while for the success of the integration process it is necessary to create an appropriate political, economic and social reality. For this, putting the legal regulations into the political, economic and social context is one of the key tasks of Croatian legal theory and practice.

In the light of these introductory remarks it is necessary then to restrict the goal of this work. First of all there will be a review of the formal steps that have to be taken on the road towards full membership in the EU, then a determination of the current Croatian position, and a comparison of this position with that of the applicant states. After that, I shall identify the contextual restrictions that could have some impact on the speed of rapprochement with the EU, and put forward recommendations for laws that have to be taken at the constitutional level and are necessary for a rapid adjustment of Croatia to standards for membership in the EU.

THE ROAD TO WELLVILLE

The process of converging on the EU could be illustrated by the title of T. C. Boyle's novel *The Road to Wellville*, which speaks of the therapeutic philosophy of the inventor of cornflakes Mr Kellogg, according to whom the route to health and happiness leads through a thorough purging of the organism. It is through such a purge that the applicant states have to pass on the road to full membership.

In principle, every European country can become a member of the EU. The making of an accession decision is a matter of a unanimous political decision of the Council of Ministers and a decision of the EP pursuant to Article 49 of the EU Treaty (EUT below), which has to be preceded by fulfilment of the conditions laid down in Article 6(1) of the EUT. Article 49 of the ET says "Every European state that respects the principles prescribed in Article 6(1) can seek membership in the Union. It shall submit its application to the Council, which shall make a decision unanimously, after which it takes counsel with the Commission, and after this obtains the assent of the European Parliament, which shall make a decision with the absolute majority of the votes of its members". According to Article 6(1) of the EUT "The Union is based on the principles of liberty, democracy, respect for

human rights and fundamental liberties, and the rule of law, which are principles common to all states members".

These conditions were additionally defined by the conclusions of the European Council of Copenhagen, according to which a state applying for membership in the Union must meet the criteria of democracy, the rule of law, respect for human rights and the protection of minorities, have a functioning market economy that can withstand the comparative pressure in the EU, and the ability to take on the obligations of membership, including respect for the criteria of political, economic and monetary union (Bull. European Commission 6-1992, Item I.13). In other words, between the point of departure – the fact that a given state is from a geographical point of view part of the European continent – and the act of being received into membership of the EU, it is necessary to pass a route that in the briefest outline could be described as a process of adjustment of governmental institutions and of economic disarmament, i.e., the gradual abolition of trade barriers, such as customs, quotas and measures with the same effect, accompanied by the reception of a large quantity, or rather, the totality, of the legal regulations of European law known as the acquis communautaire.

The EU has undergone several waves of enlargement, by which the original number of six members has been expanded to the current fifteen; a new wave of enlargement to the countries of CEE is expected in the near future. Thus the original states members – Belgium, France, Italy, Luxembourg, the Netherlands and Germany – were joined in 1973 by the UK, Eire and Denmark, in 1981 by Greece, by Spain and Portugal in 1986, and by Sweden, Finland and Austria in 1995. The current applicant countries are Lithuania, Latvia, Estonia, Poland, CR, Slovakia, Hungary, Slovenia, Bulgaria, Romania, Cyprus, Malta and Turkey. Experience from previous enlargements shows the diversity of the processes that have preceded the act of enlargement, and the diversity in the natures of the treaty relations between the Union and the countries that have joined it. The formal names of these legal instruments regulating the pre-accession period are no indicator of the final outcome of the integration process and are different for each individual example. The free trade agreements between the EU and Spain and Portugal, which mainly governed commercial relations, and which hence in scope and contents were narrower than the later association agreements, brought these countries to membership in the EU. The association agreement between the European Community and Turkey is still not totally put into practice, in spite of the fact it was

signed way back in 1963. The more recent practice of the Union shows that the precondition for joining is the signing of an association agreement, which, according to its material characteristics, sets up a free trade zone, regulating not only trade relations but covering a much wider set of material as well, involves the associated country in the accomplishment of the objectives of the Union, sets up common institutions that have legislative authority, like the Association Council; this agreement is concluded for an indefinite period of time. Turkey applied to be received as a member of the EU in 1987. In the preamble to the Decision on the Accession Partnership Decision it says: "The European Council held in Helsinki announced that Turkey is an applicant state that is predetermined to join the Union pursuant to the same criteria that relate to other applicant countries and that, developing the existing European strategy, Turkey, like the other applicant states, will have benefits from the *pre-accession strategy* that will encourage and support its reforms". As Smith and Herzog point out (Konstantinidis, ed: 1996, 51, 52):

"...association means a close and lasting cooperation with the Community. Mere interest in financial or trade arrangements that leave treaties about consultations to one side is not enough. Such treaties include only the exchange of reciprocal benefits, while association implies common objectives and a common institutional framework".

The performance of the obligations assumed via an association agreement is accompanied by reports from the European Commission and the Council. These reports are of crucial importance for an estimation of the outcome of the next step on the road to full membership of the Union – the submission of an application by an associated state for reception into full membership. After the submission of this application the next important phase is constituted by the *accession partnership*, in a formal sense, a decision of the EU Council defining in more detail the role of the EU in the process of the integration of the applicant country. The concept of accession partnership was worked out at a meeting of the European Council in Luxembourg in December 1997, when it was decided that this instrument was to be the key element of reinforced pre-accession strategy through which, within a united framework, all forms of aid to applicant countries would be mobilised in order to direct this aid towards the specific needs of each one of them.

The first accession partnerships were accepted in March 1998 pursuant to Article 235, today Article 308, of the European Community Treaty (ECT), which stipulates that "if during the work of the common market the action of the Community is necessary in order to achieve one of the objectives of the Community, and this Treaty does not provide for the necessary authorities, the Council shall, working unanimously at the recommendation of the Commission and after consultation with the European Parliament, undertake the appropriate measures". The application of this provision indicates that there are an insufficient number of treaty provisions governing accession to the Union.

The third phase in the process of the accession of applicant states to the Union covers amendments to the founding treaty, that is, constitutional changes within the Union itself, in order to make possible the full participation of the representatives of the new states members in its institutions, and in order to ensure internal cohesion in the Union (Luxembourg Council Conclusions, 1997). After a unanimous decision of the Council and the assent of the EP, an accession treaty is concluded with the applicant country. Such treaties have the significance of constitutional amendments in the legal system of the EU, and have to be ratified by the institutions of the EU and the national parliaments of all the states members.

Because of the large number of actors taking part in the association process, all of whom have the power of veto, it is impossible to predict the dynamics of the integration process. Looked at institutionally, this dynamics can be affected to lesser or greater extent by the Commission, the Council, the EP and every single member state. After the positive outcome of the referendum recently held in Ireland, which made possible ratification of the Treaty of Nice, the process of enlargement currently depends on the view of Greece about the integration of the Republic of Cyprus. As is well known, part of Cyprus is controlled by Turkish forces. Currently, the position of the Greek government is that Cyprus can become an EU member only as a single and united state, and declares that it is ready to use its right of veto on the reception of other candidates if Cyprus is not accepted. In the sequel of this paper we shall not deal with political considerations, rather lay out the political problems related to the harmonisation of Croatian law and the legal system of the EU. In so doing, we shall first of all examine the current position occupied by Croatia on the map of the accession process, and state the main problems that will have to be addressed.

CROATIA AND THE EUROPEAN UNION: THE EXISTING STATE OF AFFAIRS

Croatia signed its SAA with the EU and its states members on 29 October 2001. Through this agreement, Croatia obtained the status of potential candidate or applicant for membership in the EU. Before Croatia, the FYR of Macedonia signed a similar agreement with the EU, on 9 April 2001. For it to come into force, the Croatian SAA has to be ratified by the Croatian Parliament, the EP and the parliaments of all the states members. So far it has been ratified by the Croatian Parliament (5 December 2001), the EP (12 December 2001), Austria (26 February 2002), Ireland (17 April 2002) and Denmark (30 April 2002). In the meantime, until the SAA really comes into force, on 28 January 2002 the Council accepted an Interim Agreement which has given effect to the economic provisions of the Agreement.[i]

The first European Commission report about the process of stabilisation and association in Croatia was published on 4 April 2002 (SEC/2002/341); this can serve as the point of departure for an estimate of the progress of Croatia and a comparison of the country with the applicant countries. It is possible to discern in the report the importance of satisfying the political criteria, for it is on the fulfilment of them that the evaluation of the implementation of the whole process depends. Three main political conditions relate to the reinforcement of democracy and the rule of law, respect for human rights and protection of minorities, and to regional cooperation. As stated in the report, democratic institutions in Croatia function on the whole well. A particular problem is stated to be the judiciary, which "suffers from serious problems of organisation, procedural inefficiency, lack of expertise and the excessive length of procedures. Radical reforms are needed, and no real progress has been made. This weakness directly affects the accomplishment of the rule of law, which remains problematic and uneven" (Item 2.1., p. 4). Particular emphasis is placed on the worrying tendency for politically sensitive court decisions not to be implemented, and the execution of them is stated as a priority (Item 2.1.2., p. 6).

The priorities that need to be settled in the 12 month period after the publication of the report cover:

- redefinition of the concept of the expatriate community in electoral legislation and a proportional and appropriate representation for minorities;

- reform of the judiciary, including the settling of delayed cases, reform of legal education and training of judges and state attorneys;
- complete respect for human rights, including the passing of a constitutional law for the protection of minorities;
- legal definition of the framework of Croatian Radio Television and its conversion into an independent public service;
- reinforcement of regional cooperation;
- reinforcement of cooperation with the ICTY in The Hague and the fulfilment of existing obligations;
- acceleration of the return of property to refugees (Item 3.1, p. 14).

For the purpose of executing the obligations assumed in the SAA, the government of the EU accepted the Association Implementation Plan, according to which it publishes monthly reports. The last report was published in June 2002, and according to the latest figures, of the 128 measures that have to be carried out in the period given, 65 have been carried out. Of these 36 laws planned to be passed, 12 have not so far seen the light.[ii] Among the laws planned but not so far passed are the exceptionally important proposals through which protection of minorities, reform of the judiciary, public television, government of the system of state aid and consumer protection should be handled (Adjustments, *passim*).

If we compare the Croatian reform agenda with the current obligations of some of the applicant countries, we can see that some of them have to face similar reform problems. For example, in the area of meeting the political criteria, Slovenia has to carry out a reform of the civil service, which means the passage of a law concerning civil servants, and it has to repair the situation in the justice system, in particular by reducing the number of unsettled cases (*Report Slovenia*, 2001). The state of affairs in the judiciary, particularly in the Supreme Court, is one of the reform priorities of Hungary too, alongside which is mentioned the political obligation to improve the position of the Romany (*Proposal Hungary*). The CR, alongside the obligation to reform the judiciary and the civil service is also bound to improve the status of the Romany minority and to control the work of the police (*Proposal CZ Republic*).

However, what definitely needs stressing is that the harmonisation efforts of the individual applicant states are doubly conditioned: by the dynamics of the political, economic and legal reform processes, and by the participation of the EU in their implementation. In this con-

text, Croatia is limited by the range of the objectives and purposes of the SAA and by the political will of the EU to take an active part in and help the integration process. In this the political criteria are a signal that can speed up or slow down the integration process. Although the problems of the candidate states, like those described, are essentially similar to those faced by Croatia, it is the political evaluation of the EU about the satisfactory or unsatisfactory manner in which the criteria stated are addressed that is crucial.

LEGAL PROBLEMS AND CONTEXTUAL LIMITATIONS

The application of the SAA depends on the implementation of numerous political and legal activities defined in detail in the Implementation Plan, and can on the whole be defined as international political obligations. The implementation of these obligations depends on the effectiveness of the executive and the civil service. From a legal point of view, the application of the Agreement depends upon:

- the legal position of the SAA in the constitutional systems of the EU and the Republic of Croatia, including the possibility of applying the provisions of the SAA directly before the courts in the EU and in Croatia;
- the legal status of the bodies provided for in the Agreement;
- the legal position and legal force of the decisions that these bodies make.

With respect to the way these factors are interwoven, they will be considered in their common context.

The legal system of the law of the European Community is different from the legal system of international law. As far back as 1963 the European Court in Luxembourg adopted the stance that the legal position of the then European Community constituted a "new legal order" (*Van Gend en Loos*). The evolution of the legal system of European law has in the meantime progressed to such an extent that today one talks of the "legal system of the EU", of course, in the sense of the constitutional system of the EU as international organisation. According to practice of the European Court, association agreements are an integral part of the legal order of the Community, are applied directly, create rights and obligations for natural and legal entities and the courts of the states members are

bound to accord legal effect to the provisions (*Haegeman*). Although there are certain differences in the interpretation of the legal rules of an association agreement and of the primary European law (*Polydor*), there is no doubt that the provisions of an association agreement do have the status that, from the point of view of the EU, is equivalent and equal to that of primary European law. In the applicant states the provisions of association agreements are on the whole interpreted like the provisions of other treaties, and at the moment these countries actually accede to the EU, the legal regime governed by these contracts will be modified.

Looked at comparatively, there is nothing quite like EU accession and the legal integration that is currently under way. Certain historical similarities can be found in the US, however. For example, the debate that was once carried on between the federalists and the anti-federalists in connection with the concept of states' rights does have a certain importance for the constitutional debate in the applicant countries. The CEE countries have no precedents in their legal practice for their association agreements with the EU. For this reason it is not surprising that their legal status in the national legal systems is governed by the same constitutional provisions that govern the legal status of treaties in general. This lack of differentiation also marks, among other things, the uncertain status of the legal regulations of international law in the legal systems of these countries. For instance, the Croatian Constitution (Article 140) stipulates a monistic principle, but the bodies of government have a problem in abandoning the previous dualistic practice (Rodin, 1995; 783).

Irrespective of whether this kind of approach derives from the legal tradition and culture of socialist law that promoted a dualistic approach in the relations of national and international law (Balas) or from the idea that the integration process can be mastered by the application of existing constitutional standards, as in Italy, which considered that existing constitutional provisions were sufficient for the ratification of Maastricht, most transitional countries have been faced with a common problem that could be described as a gap between the demands of the integration process and the rigidity of their constitutional models and traditions. In other words, while the constitutional frameworks of EU states members have adapted to the relations of interdependence and gone through a process termed a constitutional revolution by Joseph Weiler (Weiler, 1991; 2403) the legal and constitutional systems of the applicant countries, or potential applicants, have remained more or less unchanged and thus are insensitive to the demands that are being made by European integration.

For all the states that entered into the type of treaty relationship with the EU described, the association agreement has meant much more than any other treaty in international law. In terms of their complexity and the nature of the obligations assumed, association agreements are a draft for an all-embracing social, economic and legal transformation, and hence permeate the totality of the social reality of the states parties. This is confirmed by Article 69 of the SAA between the EU and the Republic of Croatia, which is an example of a harmonisation clause typical of this kind of treaty or agreement: "The parties ascribe important to the harmonisation of existing Croatian legislation with the legislation of the Community. Croatia will endeavour to ensure the gradual harmonisation of existing laws and any future legislation with the legal patrimony of the Community (the acquis*)*." In the area of law, the obligations assumed pursuant to the SAA include the obligation to carry out complex and radical constitutional and legal reforms. As Chris Patten recently said, speaking of SAAs in general: "These treaties are legally binding agreements. They prescribe rights and transfer rights to the states they refer to. These are strict agreements, because they include the fundamental principles that are the foundation for membership in the EU – free trade with the EU and the associated disciplines, the principles of market competition and the rules about state aid, rights of intellectual property and so on".[iii]

Apart from the need for the fulfilment of the material provisions of the association agreement, it is also necessary to carry out a reform to be able to create an interface between national and European law, to open up the legal systems of the application countries for the application of the supranational, European legal sources. This kind of interface should give legal definition to the status of European law in the national legal system, and allow for direct implantation of Community law and "association law", i.e., law that is based directly or indirectly on the SAA. There are at least two additional elements of such an interface, which we shall not embark on in detail here. These are the constitutional basis for association with/accession to the EU, and an appropriate and effective national institutional framework making it possible to run an effective integration policy, which implies the need to create a pro-Europe consensus to facilitate the accomplishment of the other aims stated. Applicant countries have addressed these problems in different ways, and there are considerable differences in the provisions concerning the status of treaties in their legal systems.

In Bulgaria, for instance, ratified treaties that are in force are equivalent to national regulations and have a legal force above statutory law (Constitution, Article 5). In the CR, treaties that govern the material of human rights are "*immediately binding*" and have a force above statute. Thus Article 10 of the CR Constitution states: "Published treaties the ratification of which has been accepted by Parliament and which bind the CR are part of the legal system; if the treaty is different from statute, then the treaty must be applied" (395.2001 Sb [Official Gazette]). The Estonian Constitution (Article 3) and the Hungarian Constitution (article 7) speak only of general rules of international law, but the Hungarian in addition defines the obligation to harmonise national law with international obligations. Article 9 of the Polish Constitution stipulates the obligation to respect the obligatory rules of international law, and Article 87 says that ratified treaties are a source of national law. The Slovak Constitution, Article 7 (5) prescribes the derogatory power of directly applicable treaties vis-à-vis the usual laws: "Treaties concerning human rights and fundamental liberties, treaties that do not require implementation pursuant to the law, and treaties that directly prescribe the rights and obligations of natural and legal entities, and which have been ratified and announced in a manner prescribed by law, have priority over Slovak laws." The Slovene Constitution (Article 8) affords perhaps the most comprehensive solution for the application of treaties, which, once ratified, may be implemented directly. The Croatian and Macedonian constitutions (Articles 140 and 118 respectively) say that ratified treaties constitute part of the national legal system and supra-statutory legal force is guaranteed for them. However, these constitutions say nothing of the direct implementation of treaties. Nevertheless, the possibility of the direct application of treaties does exist in Croatia, and sometimes the Croatian courts will allow them to have immediate effect.

Such a diversity of constitutional solutions should not be surprising in the light of the fact that even within the EU the states members have various different approaches to the status of the legal regulations of international law. Thus the UK accepts a pronouncedly dualistic concept, while the Netherlands is an example of legal monism. Nevertheless, this diversity of approach does not have any effect on the final outcome, i.e., on allowing the legal rules of European law direct effect. As for the applicant states, the lack of constitutional standards to regulate the effects of European law shows that most applicant or associate states do not differentiate between association agreements and the rest of international law.

In a word, from the point of view of constitutional law, and in the absence of any specific constitutional provisions specifically to govern association agreements, the interpretive paradigms that are applicable to these associations are the same as those that are applied to other international law agreements, and their direct application is not automatic, that is, they do not have a *self-executing* character, irrespective of the understanding of the European Court, which the courts of the associated countries are not obliged to consider. Although there is some technical justification in this approach, it can lead to difficulties in the application of association agreements and the process of the harmonisation of national with European law. We will mention the instance of only one associated country that does not admit *self-executing* status to the association agreement, and yet in joining the EU will take on the obligation to ascribe this status to all other agreements that the EU has previously entered into with third states. Even if this does not technically create a problem, the very change of the interpretive paradigm will require a certain adjustment. Although the absence of express provisions about the position of an association agreement in the national constitutions does not prevent national courts from implementing them, the fact that they do not exist must certainly discourage the courts from applying them. As Cremona puts it (Craig and de Burca. 1999; 143): the relation between the legal systems is a matter of the legal system of the Community, irrespective of the views that the other contractual part has; bona fide execution of a contract in the sense of international law is not conditional upon the legal mechanisms that the parties might choose to accomplish its objectives. For this reason, as long as both sides fulfil their obligations, the fact that one party ascribes direct application to the provisions of the treaty, and the second does not, will not affect the reciprocity of the treaty.

The problem of the direct implementation of the laws of the association treaties is exacerbated by the fact that the association agreements invoke the implementation of the law of the European Community in their application. For example, Article 63(2) of the Hungarian association agreement says that every practice that is in contravention of the provisions governing market competition "*shall be judged pursuant to the criteria that derive from the application of articles 85 and 86 of the Treaty [of Rome]*". There is similar diction in other association agreements, and it is taken over in the stabilisation and association agreements. Thus Article 70(2) of the EU and Croatian SAA says: "Every action in contravention of this Article shall be judged pursuant

to the criteria that derive from the application of the rules about market competition in the Community, especially articles 81, 82, 86 and 87 of the EUT and interpretive instruments adopted by the institutions of the Community". This wording shows that the associated countries have not only assumed the obligation adopting the rules of the European Community about market competition, but have also committed themselves to interpreting these rules according to the way the community itself interprets them. In this way elements of the acquis are being brought into the legal relationship that in the associated countries is understood as a relationship of international law.

When the Constitutional Court of Hungary had to face these problems, it concluded that the "principle of *favor conventionis* will be applied to the limits up to which such a kind of interpretation of national law in line with international would be understood as a breach of the Hungarian Constitution" (Volkai, 1999). Thus the Hungarian Constitutional Court has adopted a way of thinking similar to that from the previous constitutional practice of the constitutional courts of some of the member countries, especially of Italy, in the *Frontini* case, or Germany in the *Maastricht* cause. The decision of the Hungarian Constitutional Court is explained in greater detail than any other similar decision in the associated countries, i.e., a decision addressing the relationship of national law and the legal system of the EU. However, however much the logic of this decision might seem correct, it has not settled the main problem. The Europe Agreements provide for the application of the laws of the EU in market competition so that these rules should promote economic rationalisation and facilitate the integration of the associated countries into the EU. The non-application of these legal rules in the associate membership period would undermine the very goals of the association agreement. Finally, association agreements differ from the other treaties in international law in that their objective is the accession of a state party to the EU. For this reason, the courts, I would hold, would have to take this objective into account in the interpretation of the agreements. An opinion of the Polish Constitutional Court[iv] would tend to confirm this; it expressed its readiness to interpret national law in the light of the laws of the Community, and this is justified by the need to respect obligations assumed pursuant to the Europe Agreement.

"Naturally, EU law does not have any binding power in Poland. The Constitutional Court, however, wishes to stress the provisions of articles 68 and 69 of the Europe Agreement in which an association between the

Republic of Poland on the one hand and the European Community and its states members on the other was established. Poland thus has the obligation to undertake ... everything it can in order to ensure that future laws shall be harmonised with the regulations of the Community."

And further:

"... The Constitutional Court considers that the obligation to ensure the harmonisation of the legislation (which pertains primarily to the government and to the Parliament) also creates the obligation that the existing laws should be interpreted in such a way as to ensure the highest possible degree of such harmonisation."

Some German authors, Bleckmann for instance, consider that the Europe agreements have not created any kind of supranational legal system and that they remain within the domain of classic international law. This understanding is backing up by the claim that the European Community is a creation of international law, and that, in line with this, its states members remain "masters of the treaty". According to this author, the institutes founded pursuant to an association agreement, i.e., the decisions of the Council for Stabilisation and Association, do not of themselves have any legal application in the legal system of the EU or in the legal systems of the states members, but should rather be incorporated into the secondary legislation (Bleckman, 1997; 503). This opinion has been subject to increasingly severe criticism. Thus Pernice says:

"An estimate of the many proposals discussed and consideration of concrete steps for the explanation and, if necessary, supplementation of the European system of competences in a changed constitutional treaty should be based on a common understanding of the actual nature of the Union. My view is that it is not an international organisation the masters of which are the states members the instruments of which comprehend their citizens because the instruments of the member states recognise their validity. I propose that this be conceived as a multi-level constitutional system that consists, depending on the case, of local, regional, national and European levels of political integration and action and for this reason as a system of multi-level competences that are established so as to be able to satisfy the needs of the citizens at an appropriate level as effectively as possible."

Article 6 of the Croatian Implementation of the SAA Law (NN MU 15/1991) is an example of a radically dualist approach, decisions of the Stabilisation and Association Council having to be ratified by the Croatian Parliament. This is a deviation from the monistic principle laid down in the Constitution, in Article 140, according to which ratified treaties do make a part of national law; however, the constitutionality of this provision is questionable.

This point of view, which is not alone in the constitutional practice of the associated states, is in contravention of the settled practice of the European Court as developed in the interpretation of earlier association agreements. Apart from that, I would say that such practice does not contribute to efforts for the adjustment of national law to the legal system of the European Union. It is, that is, possible, as alternative to the classical approach of international law to find different solutions, and some of these possible solutions are indeed in accordance with the common practice in the interpretation of treaties. An obvious example can be found in the *favor conventionis* interpretive principle, that is, in the interpretation of national law in accordance with the treaty. This concept is well known, and by way of example Germany or England and Wales can be cited (McCarthy v Smith; Hood Phillips: 1980, 31). In Germany this concept is known as *Völkerrecht-freundliche Auslegung* and its application is not limited to the law of the EU. As explained by the Federal Constitutional Court in the interpretation of the European Convention on the Protection of Human Rights and Fundamental Liberties "all laws, present and future, must be interpreted in the light of the Convention" (BVerfGE 74, 358/370/; Frowein: 1987).

According to this approach, the national courts of the associated countries can interpret the provisions of national law in accordance with the association agreement, taking into consideration the current state of affairs of the acquis, including the practice of the European Court. Such practice could well lead to gradual acceptance of the direct effect of directly applied provisions of primary and perhaps of secondary law too that derive from the association agreement. An argument in favour of this approach is that the associated countries, assuming their treaty obligations, did intend to conform their national legal systems to the legal system of European law. The consequence of such an intention is the obligation to interpret national law and the association agreement in line with the acquis communautaire. But this still does not mean that the relation between the Union and a partner country has features of the constitution of the EU (Cremona 2000, 92).

REFORM OF THE FRAMEWORK OF CONSTITUTIONAL LAW ENTAILED BY THE PROCESS OF EUROPEAN INTEGRATION

The outlook for Croatian full membership of the EU requires the implementation of constitutional modifications and the amendment of a number of legal approaches. Some of these changes are necessary right at this moment, as part of the implementation of the SAA, and some are essential because of the outlook of full EU membership. However, it is assumed that Croatia will best express its genuine desire for full membership of the EU by now, at the constitutional level, creating the assumptions for full membership. The proposed changes can be put in a number of groups. They are:

a) provisions that provide the legal basis for EU membership, including the government of the manner in which state sovereignty is exercised;
b) provisions that define in more detail the legal status of international law and European primary and second law within the internal legal system of the Republic of Croatia;
c) provisions through which the constitutional organisation of the Republic of Croatia is adjusted to the conditions of associate or full membership in the EU and the functions of the institutions of government that will have to work in new conditions are optimised;
d) provisions that govern the jurisdiction of the Constitutional Court.

With reference to a). The existing constitutional definition of state sovereignty is insufficiently adapted to the conditions of membership of the EU. For this reason it would be necessary to stipulate that state sovereignty cannot be alienated, or divided or transferred in the sense of the presently valid Article 2 of the Constitution, but is used in concert with other states. This change is based on a contemporary understanding of sovereignty as a possibility of taking part in the making of decisions in international relations (not *summa potestas* but *a* place at the table).

With reference to b). The second part of the proposed modifications relates to settling and defining the status of European law in the Croatian legal system. In this segment it should be stipulated that treaties that are of a self-executing nature (that are clear, unambiguous and unconditional) need not be additionally processed but simply

directly applied, i.e., they serve as the legal base for the making of individual acts. This goes for all treaties that are of a *self-executing* nature, for example, for the European Human Rights Convention, and certainly for the SAA, and for all legal standards that are based on this agreement. According to the current state of affairs, Article 6 of the SAA Implementation Law starts from a radically dualist understanding, the decisions of the SA Council having to be ratified by the Croatian Parliament. This kind of approach deviates from the monistic principle laid down in the Constitution, according to which treaties are automatically a part of the legal system of the Republic of Croatia, although the constitutionality of this, as we remarked earlier, is disputable.

With reference to c). In the conditions of associate, and in particular of full, membership of the EU it is necessary to coordinate the working of the main institutional stakeholders, particularly the parliament and the government. Considering that the SAA was not ratified by the two thirds majority necessary to enable transfer of regulatory authorities to the SA Council, the Croatian government has to carry out the decisions of this body. It would here be sensible to prescribe the obligation of the government to inform the Parliament in due time about its regulatory activities related to the execution of its treaty obligations. The current state of affairs is regulated by Article 112, Paragraph 4 of the Constitution, which authorises the government to make decrees for the execution of the laws, and hence decrees for the execution of the law concerning the ratification of treaties, but only those that have been ratified by an ordinary majority. This is logical, because this manner of ratification does not make it possible to transfer legislative authority to bodies founded by treaties. Since this is concerned with decrees for the execution of a law, it is logical that the Parliament should be informed in advance. Still, in this area of regulation the government does have original constitutional authority and the parliament can prevent the government passing them only by a vote of no-confidence. However, the need for the government to take part in the passing of decisions in the SA Council, and later in the Council of Ministers of the EU, calls for a change in the existing solution; it is necessary to provide for direct constitutional authority of the government to take part in the making of such decisions, with the simultaneous obligation to inform parliament regularly about this kind of activity. A similar approach has been provided for in the French Constitution. A special problem is a situation when, for the implementation of a treaty, it is necessary pass some law, or when the legal mate-

rial that the treaty regulates belongs to the area of so-called legislative reserves. This is the case, for instance, with electoral laws. Then it is necessary for the legislative government to take part directly, but only if a treaty is not of a *self-executing* nature. If it is a *self-executing* treaty that is concerned, no additional legislative regulation will be needed, rather the treaty is applied directly. For this reason it should be prescribed that the parliament may transfer its legislative authority to the government if two conditions are fulfilled: a) that a treaty is not *self-executing* and b) it is not a legislative reserve that is concerned.

With respect to d). Changes are necessary too in the area of the authority of the constitutional court; some of these changes have already bee introduced in the practice of this court.

Firstly, it is necessary to say that the Constitutional Court should decide whether, before the ratification of some treaty, it is necessary to carry out constitutional changes. If no changes are necessary, there is a presumption of the conformity of the Constitution and the treaty and the ratification of it ceases to be a problem of constitutional law. Similar solutions exist in the constitutions of Germany, Slovenia and elsewhere. For a complete legal settlement of this institute in the Republic of Croatia it is necessary to put through modifications of the Constitutional Law concerning the Constitutional Court. This law, that is, has to prescribe who can start off this procedure, and it would be good for it to be the same persons that can launch a procedure for the abstract evaluation of constitutionality. For the needs of full membership in the EU (but not before) it is necessary to define constitutional procedural law so as to bring it into line with the practice of the European Court, as for example in *Simmenthal*. This can be done via amendments to the Constitutional Law and/or by changes in the Courts Law. The contents of these changes would relate to a change in the legal institute of *exceptio illegalitatis* by the regular courts in the event of some lack of harmonisation of some legal regulation of Croatian law with some regulation of EU law. This would bypass the need for the procedure of the abstract evaluation of constitutionality before the Constitutional Court.

Secondly, it is necessary, along the lines of German constitutional law, to introduce the competence of the Constitutional Court to adjudicate on the existence of legal rules of universal international public law. This must be done in every case, particularly for the purpose of the SAA and later full membership in the EU, since in European law, the standards of universal international law are regularly applied, and from this point of view, our legal system has to be brought into line.

Thirdly, the possibility for the Constitutional Court to evaluate the compliance of laws and other regulations with treaties already exists today pursuant to the practice of the Constitutional Court of the Republic of Croatia, according to which it has been established that contravention by a law of a treaty is at the same time a violation of Article 5 of the Constitution, i.e., of the principle of constitutionality and legality. This practice is thus made constitutional. However, because the legal regulations of European law, including the legal regulations made by the SA Council, according to well-established rules of European law, have a supra-statutory force and many of them are self-executing, it will, from this point of view, be necessary additional to handle Croatian procedural law in order to avoid the Constitutional Court having to decide on the accord of laws and byelaws with secondary sources of European law, for this would be in contravention of European law. In any event, when the Republic of Croatia becomes a full member of the EU, the Constitutional Court will not be able to evaluate the accord between a law and the European Union Treaty, rather it is the European Court in Luxembourg, pursuant to Article 234 of the EUT, which will decide on whether such laws are in breach, and regular courts will have exempt such laws, against the laws of the Community, from practice.

FINAL CONSIDERATIONS: CROATIAN AND EUROPEAN LEGAL CULTURE

The legal position of the SAA in Croatia is different from its position in the EU. While in the EU the legal standards of the Agreement are part of the internal legal system and are applied directly, in Croatia a practice necessarily is called up that, quite against the intentions of the Croatian Constitution, insists, out of sheer inertia, on additional legislation as the modus for the implementation of treaties, hence of the SAA. This practice also exists with respect to the legal standards that come into being through the regulative activities of the bodies set up by the SAA – secondary legal standards – which according to current legal approaches will not be directly applicable in Croatia, but will at the same time be directly applicable in the states members of the EU. For this reason legal protection against violations of these standards will be possible before the courts of states members, the European Court and the First Instance Court, but not before Croatian courts. This problem is not only a technical one, but very

largely is of a conceptual nature. The law of the European Community, the moment Croatia becomes a member of the EU, will become Croatian law too; but the SAA is a transitional instrument – a means that enables the gradual acceptance of the legal patrimony of the EU, the acquis. Understanding of the SAA and the secondary law of which it is the basis as source of international law does not help this process. The adjustment of the Croatian legal system with the European does not just mean the reception of a vast number of legal standards with the constitutionally established conditions, but an organic and functional integration and melding of the national (Croatian) and supranational (European) legal systems.

The Europeanisation of Croatian law means above all a bridging of the legal culture gap that has been brought about by many years of detachment from the European and world mainstream. For Croatia, at the level of legal theory, what started to develop in Europe with the teaching of Rudolph von Ihering and his rejection of the dogmatic approach is very relevant (Ihering, 1872); this created the ideological premises for the creation of a "new European legal culture" that, as Hesselink says, is positivist (because it is occupied with positive law here and now) and dogmatic (for it is based on the assumption that a legal system is coherent and integrated, and that for a given legal question there is only one proper answer). Under the impact of European legal standards, traditional culture was transformed and became informed by substantial elements, analytic, interdisciplinary, critical (Hesselink, 2001). In the USA a similar process started to develop with the work of Oliver Wendell Holmes, begetter of the school of legal realism. Characteristics of both processes are a break with the way of thinking connected with the forms of law, directed at legal concepts that ignore the reality, and a *down to earth* approach to legal problems, which is best expressed, perhaps, in the famed sentence of Holmes that in studying law we do not study any kind of mystery, but a well known profession. The break with traditional legal culture on both sides of the Atlantic has enabled a convergence with analysis of standards with that of economics, society and institutions; it is precisely this radical break that will turn out to be the key assignment of Croatian legal theory and practice in the modernisation of the legal system.

Traditional legal culture in Croatia has made possible the inveterate acceptance of the understanding that since, after all, the Croatian legal system is founded upon the fine traditions of Roman law, of Austro-Hungarian, Germanic, Central European and who knows what other traditions, that for its harmonisation with the demands of Europe

it is only necessary to accept a given number, true, a very large number, of legal rules; this is, after all, a merely technical task. This kind of legal optimism has contributed to the flood of legal institutes for which there is often no real social grounding, and no opposed interests in the settlement of which the legal rules should be made concrete, to do with which legal doctrine should be developed. Quite the opposite to such an understanding, in the context of meeting the criteria for membership in the EU, the measure of conformity and adjustment of the legal system will be seen in its fruits, that is, the political, economic and social substances that are governed by these legal standards, and this need to be determined empirically.

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[i] *The Interim Agreement was ratified in the CP on 5 December 2001, Official Gazette, Treaties, no. 15.2001, and has been in force since 1 March 2002, pursuant to the Announcement of the MFO of the Republic of Croatia of 5 February, Official Gazette, Treaties, no. 3/2002, 22 February 2002.*

[ii] *Cf Jutarnji list, Wed. 4 September 2002, "Croatia has not met even a third of its obligations to the EU", p. 7*

[iii] *European Commission at the Regional Conference for SEE (Stability Pact), speech by the Rt Hon. Chris Patten, CH, Member of the European Commission for External Relations, Speech/01/489, Regional Conference for SEE, Bucharest, 25 October 2001.*

[iv] *East European Case Reporter of Constitutional Law 271, at 284 (1998). Article 68 of the Polish Europe Agreement says: "The parties agree that an important condition of the economic integration of Poland into the community is the harmonisation of current and future Polish legislation with the legislation of the Community. Poland will endeavour to make sure of gradual harmonisation of existing laws and future legislation with the legal patrimony of the Community (the acquis)." Article 69 of the Croatian SAA contains a similar provision.*

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Chapter 11

THE NON-GOVERNMENTAL SECTOR AND THE GOVERNMENT: A DIALOGUE FOR EUROPE

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ABSTRACT

This paper discusses the opportunities for and obstacles in the way of a dialogue between the Croatian government and the non-governmental sector within the context of the European integration process. Although the development of civil society, the building of institutional and administrative capacities and the strengthening of cross-sectoral dialogue are fundamental preconditions for the implementation of the overall adjustment to the EU, there is no clear list of priorities and demands on the basis of which it might be possible to monitor the progress made in this area by candidate and potential applicant countries for membership. Because of the lack of any clearly defined acquis, several strategic documents of the European institutions and the existing literature about the advances made by applicant states will be used as a point of departure for the analysis. The main guidelines for and obstacles to reform in this area in Croatia will be picked out in the light of the European criteria of good governance and the relevant experience of applicant countries.

Key words:
civil dialogue, non-governmental organisations (NGOs), the third sector, the government, Croatia, the EU, SAA

INTRODUCTION

Civil dialogue, that is, a dialogue with non-governmental organisations (NGOs)[i] has in the last few years become a very important EU topic. The non-governmental sector has grown into an identifiable social, political and increasingly an economic factor in the whole of the EU. One of the reasons for the increasing importance of a dialogue with the NGOs in the Union should be sought in part in the worrying results of public opinion polls which show a low level of understanding on the part of citizens of EU member states of the complex structures and mechanisms in which the European institutions work. This lack of understanding is directly manifested, for example, in the increasingly poor turn-out of voters at elections for MEPs, while not long ago this was reflected in the Irish voters at a recent referendum turning down support for ratification of the Treaty of Nice, thus bringing into question the future enlargement of the Union.

The purpose of this paper is to evaluate the quality of the dialogue between the Croatian government and the non-governmental sector[ii] in the light of the standards of good governance that have been developed, or are still being developed, at the EU level, and in the light of the experience of chosen applicant countries for Union membership. The process of the implementation of the Stabilisation and Association Agreement (SAA) between Croatia and the EU will be analysed as a potential catalyst for the strengthening of the culture of dialogue and consultation, first of all at a national and then at regional and local levels.[iii]

EU POLICY TOWARDS THE NON-GOVERNMENTAL SECTOR

In official EU documents the non-governmental sector started being mentioned no earlier than the eighties. During the almost thirty years from the signing of the Treaties of Rome, collaboration with the NGOs was looked at exclusively as part of the sphere of competence of the member states, and the only European initiatives in the area were related to the work of EU agencies for aid to developing countries (Kendal, Anheier, 1999). At the beginning of the nineties, thanks

mainly to the new institutional and symbolic framework given by the Treaty of Maastricht and the concept of a Europe of citizens, there was a sudden rise in the number of NGO networks actively involved in lobbying and in a dialogue with European institutions, and a move to a gradual explicit acknowledgement of their role in EU strategic documents.

The development of EU policy vis-à-vis the third sector is linked with a number of difficulties. Firstly, though most member states of the EU have a very long tradition of civil society and democratic culture, there are considerable differences among them in the modalities of relations with non-governmental associations and the circumstances accompanying the development of this sector. Secondly, the activities of the European NGOs were mostly concentrated in areas that were traditionally in the sphere of competence of the member states, and not the EU (Kendall, 2001). Thirdly, the non-governmental sector within each one of the member states is highly heterogeneous and composed of organisations of very different aims and structures, which makes it much more difficult to construct a common and all-encompassing policy. The next difficulty is related to the absence of a common definition of the scope and significance of the concept of a non-governmental association, and the consequence of this is quite often an uneven employment of the vocabulary inside EU documents. Finally, because of the so-called horizontal[iv] nature of policy towards the NGOs, which does not fit into a single one of the traditional vertical sectors or interests related to them, it is hard to provide appropriate institutional and financial capacities for the development of such a policy, which is, after all, a problem that the member states have to face at their national levels as well. These difficulties have been manifested in recent years, particularly in the context of the frequent unsuccessful attempts at adopting the so-called charter of European associations in the Council of Ministers, the acceptance of which would make it much easier for NGOs to work across borders.

Although it is not codified in the Amsterdam Treaty, nor is it a part of the acquis, the legal patrimony of the EU, EU policy with respect to the third sector has in time gained in importance in a number of strategic EU documents. This is the consequence of active NGO lobbying at European institutions via powerful cross-border sectoral networks (Preston, 1998; Weisbein, 2001), as well as the increasingly marked economic roles of the associations, particularly

because of the contribution they have made to increased employment[v]. In addition, a cause can be sought in the increasingly large role given to the NGOs in the context of reform of institutions and of the future enlargement of the Union, as they are seen as potential factors of the Europeanisation of civil society and catalysts of transnational solidarity among present and future EU member states (Warleigh, 2001).

Among the first rather important documents to lay down the principles on which the European institutions should work with the NGOs was the European Commission communication of 1997 entitled *Promotion of the Role of Volunteer Organisations and Foundations in Europe* (COM/1997/241 final). This document defines the reason for setting up a powerful civil dialogue at the European level, alongside the existing political dialogue with the national state bodies and the dialogue with the social partners. The aim of this document is to illustrate the increasingly large importance of third-sector organisations within the EU, to draw attention to the problems and challenges these organisations have to face, and to improve their ability to make an even more active contribution to European integrative processes.

Not three years after this announcement came a European Commission discussion paper called *The Commission and NGOs: Building a Stronger Partnership* (COM/2000/11 final). This document proposes measures to beef up the relations between the Commission and NGOs; the common features of NGOs are defined and concrete proposals formulated for an improvement of the existing dialogue with the associations. The impact of this document has been underlined by the particularly large number of reactions to it which have arrived from both member states and candidate states.[vi]

As answer to the results of public opinion surveys in member states that show a very low level of citizen support for and informedness about the work of European institutions, in mid-2001 the European Commission published a white paper about European governance (COM/2001/428 final). The white paper lays down the ground for a reform of the system of governance at all levels, from European to national and local levels, and defines the principles and guidelines for the strengthening of relations between European institutions and the non-governmental sector, and for bringing the NGOs more actively into the process of defining and implementing EU policy[vii] via numerous consultative mechanisms.

CONSULTATIVE MECHANISMS WITH THE NON-GOVERNMENTAL SECTOR AT THE EU LEVEL

The difference in the level of development of dialogue among some of the EU institutions and the non-governmental sector is linked directly with the degree of supra-nationality in their work. In other words, institutions in which disparate national interests are represented, such as the Council of Ministers, the European Council, or the *Committee of Permanent Representatives of Member States* – COREPER, because coordination among the member states is more difficult, are in a much less propitious position for the development of dialogue with associations than, for example, the European Commission, the European Parliament and the Economic and Social Committee of the EU. Of all the institutions, the European Commission has made the most progress in formalising and institutionalising consultation and dialogue with the non-governmental associations.

The European Commission has over time developed two kinds of consultative mechanisms with the NGOs: the open and the so-called focused consultative mechanism. Open consultative activities are carried out via a number of official documents calling for public debate about individual proposals of new Union policies. Since such documents give rise to a large number of reactions not easy to process in a reasonable time, in 2001 the European Commission launched its so-called *Interactive Policy-Making Initiative* – IAPM), in which, via the Internet, the reactions of the very general public to the process of making decisions and policies at the level of the EU can be collected and analysed (C/2001/1014).

Focused consultations are done via formal consultative forums and committees that the Commission founds formally, and also via the work of various *ad hoc* consultative bodies with invited representatives of relevant sectoral interest groups. For the sake of greater transparency in the work of the said consultative bodies, the Commission has founded a database on the Internet entitled CONECCS (*Consultation, European Commission and Civil Society*) which contains information about the composition and working methods of the consultative forums and other bodies via which the Commission consults with NGOs and, in general, with the organisations of civil society in a formal and structured manner, as well as a directory of such organisations at the EU level.[viii]

Prompted by the need to strengthen the culture of consultation and dialogue at the EU level, and at the national levels of current and future member states, in June 2002 the Commission published a communication with the title *Towards a reinforced culture of consultation and dialogue* (COM/2002/277 final) which contains a code with general principles and minimum standards for Commission consultation with NGOs.[ix] The adoption of such a code was envisaged in the White Paper on European governance, and was prompted by a broadly accepted view that the culture of consultation can hardly be reinforced by legal regulations, which could lead to excessive rigidity and hold up the adoption of some policies.

The general principles for consultation with NGOs are taken from the White Paper on European governance, and they are: participation, openness, accountability, effectiveness and coherence. By promoting the principle of participation the Commission binds itself to enable as many NGOs as possible to take part in the development and implementation of EU policies. The principles of openness and accountability are there to ensure transparency of consultation, primarily through a precise explanation of the topics and mechanisms of consultation and the availability of information about the participants in the consultative process and the reasons for their choice, as well as factors that affect the final shaping of policies. In line with the principle of openness and accountability, associations that through consultation endeavour to contribute to the development of EU policies should be able to explain whose interests they represent and just how comprehensively they do represent them.

Effectiveness of consultation implies involving the non-governmental sector in the development of policies, right from the stage in which it is still possible to have an effect on the definition of the principal objectives, the methods, performance indicators and initial drafts of policies. Here it is important to pay attention to proportionality, that is, the need for the methods selected and the dimension of the consultation to be proportional to the influence and importance of the policies proposed.

Finally, the Commission binds itself to ensure the coherence of the work of its departments in the consultative processes, and to include *feedback*, evaluation and review mechanisms in the consultative process. Just the same, the NGOs are expected to provide mechanisms for keeping up with the consultation process and to contribute to the creation of a more transparent, open and accountable system.

Alongside these general principles, the Commission has set up minimum standards for the process of consultation with the NGOs. For open consultation, meant for the general public, these standards refer to clarity of the contents of the consultation, the publication of any documents that are the subject of the consultation in a format adapted to the broadest possible circle of target groups, to time limits for participation in consultation and the establishment of mechanisms to confirm the receipt of reactions to the proposed new legislative measures and proposals for new Union policies. In connection with focused consultations within the context of the consultative forums and committees, standards and criteria have been set up that the Commission is supposed to respect while determining the NGOs that are relevant for inclusion into the consultation process.[x] The following factors will also be taken into consideration: the potential impact of the proposed policies on other areas, the need for particular experience, expertise or technical know-how, previous participation in consultations and the need for balance where it is crucial, i.e., among representatives of large and small organisations, social and economic figures, broader and narrower target groups and organisations from the EU and non-member states.

Although it does not have any legally binding force, it is expected that this code will prove its real value in practice and that in time it will become a foundation upon which a dialogue between NGOs and European institutions will be built, as well as a stimulus for the adjustment of policies to the non-governmental sector at national levels of current and future member states.

THE EU ENLARGEMENT, THE NON-GOVERNMENTAL SECTOR AND CIVIL SOCIETY

In order to meet the so-called Copenhagen political criteria for membership in the EU (defined at a meeting of the European Council in Copenhagen in 1993), it is not mere lip service to the principles of the rule of law, human rights and protection of minority rights that is expected, rather the everyday application of them and the introduction of the necessary institutional background as warrant for their sustainability. The stability of democratic institutions is tightly linked to the

level of open, civil society, and for the development of organisations of the non-governmental sector that supplement the activities of the state and the market economy.

The development of civil society, the construction of a civil dialogue, and the development of institutional and administrative capacities and reforms of the civil service are not codified by the Treaty of Amsterdam, and for these areas there is no list of legally binding norms to facilitate the process of adaptation to the EU for future members. Still, meeting the said requirements is a precondition for joining the Union, and for full success in the process of European integration. A dialogue with the non-governmental sector has been for decades a component part of political, social and economic culture in EU member states, and it cannot be instilled by mere decree or directive into countries or societies that because of their political past have not been able to develop this kind of culture. Because of the absence of clearly defined standards in the area of the working of the government with the non-governmental sector and in general for the construction of civil society it is crucially important to have an exchange of experiences and know-how among current and future member states.

In order to help the candidate states to meet the political criteria for membership in the EU, the Union has launched a series of initiatives meant to reinforce civil society in these countries. In several countries, via PHARE programme resources, foundations have been set up for the development of civil society. The role of these trusts is to strengthen the organisations of the non-governmental sector so that they should become capable of developing a high-quality dialogue and partnership with the government administration at all levels. Special programmes were set up with PHARE resources, called Lien and Partnership, and they worked between 1993 and 1999. While the Lien programme was founded in order to encourage ideas and fortify the abilities of associations working with groups in the applicant countries that were disenfranchised or at risk, the Partnership programme was meant mainly for the support of local economic development and collaboration among the private sector, local government and the non-governmental sector. In 2000, the ACCESS programme replaced these two previous programmes.[xi] This is an endeavour to bolster the development of democratic processes in CEE countries through the strengthening of the institutional and operational capacities of NGOs in sectors that are relevant for the installation of the acquis, and to encourage the involvement of groups that are socially, politically and economically

marginalized. One of the main aims of the programme is the involvement of the NGOs of the candidate states in activities of the networks and platforms of NGOs at work at the level of the EU.

EXPERIENCES OF CANDIDATE STATES

In the CEE states that have the status of candidates for membership in the EU there is no lasting tradition of government cooperation with NGOs. Nevertheless, as a result of EU pressure, and encouraged by the need to obtain the support of members of the public for reforms that are required by adjustment to the Union, most of the applicant countries have developed certain formal and informal mechanisms for consultation with the non-governmental sector.

Via its Office of European Integration, the Slovene government, at the beginning of negotiations with the EU, sent a public invitation to NGOs to get involved in the process of preparing the country to join the Union.[xii] Consultation with the NGOs is conceived in the form of public conferences to precede the drafting of negotiation positions for given topic areas of the acquis in the various ministries. Only after the debate with the NGOs would the negotiating position be sent to the government, the Parliament, and then after all to Brussels. Research carried out in the Slovene ministries has shown a very low level of response on the part of associations to this form of informal consultation, and brought out a number of fundamental obstacles in the way of setting up a structured civil dialogue. Among the main problems are an inadequate level of knowledge and information about European integration among Slovene NGOs, the lack of coherence and coordination within the non-governmental sector and the absence of any mutual trust in relations between government and associations. During 2001, the Slovene government passed decrees aimed at a better structuring of its dialogue with the associations, primarily the foundation of a Commission for Collaboration with the Organisations of Civil Society, a horizontal body of the government composed of governmental officials from various ministries, through the work of which a common government strategy for the development of civil society would gradually be produced. Also passed was a decision about the establishment of a more formal form of consultation with NGOs by the foundation of expert committees for various areas in which the representatives of the societies for a given sector would be appointed by the associations

themselves, and not by the government. The process of appointing representatives turned out to be a great challenge for the non-governmental sector and drew attention to the very low level of internal democracy in the associations.

A year before the beginning of negotiations concerning joining the EU, the European Integration Office of the Polish government started off the process of consultation with NGOs and other organisations of civil society within the so-called partner groups, which, as expert consultative bodies, are supposed to work in parallel with the working groups set up for the sake of drawing up negotiating positions for each chapter of the acquis. The dialogue between a negotiating team and the partner groups is considerably hampered because of the specialised bureaucratic language in EU documents, intelligible only to a narrow circle of employees in the structures of the administration, and an additional hurdle turned out to be an inadequate understanding of foreign languages, because it was infeasible to translate hundreds of pages of EU documents for each meeting with the partner groups. These obstacles led to a gradual weakening of the links with the partner groups, and in the advanced phase of the negotiations the dialogue with representatives of the NGOs turned from consultations into the mere transmission of information about the progress of the negotiations (Hausner, Marody, 2001).

The challenges faced by the Slovene and Polish governmental and non-governmental sectors are very largely paradigmatic for the other countries of CEE. There have been attempts to solve the problem of inadequacy in the organisation and coordination that are preconditions for a sustainable and constructive dialogue with the government in several of the applicant countries by the founding of a centre, forum or network to facilitate the consultation process. This objective, for instance, led to the foundation of the NGO Centre of Slovenia (CNVOS), the National Forum of Hungarian NGOs entitled Civil Europe – Civil Hungary and the Polish Forum of Non-Governmental Initiatives (FIP).

One of the great successes of the Polish Non-Governmental Initiatives Forum, which served as a spur to NGOs in other applicant countries, was the foundation of the Polish NGO Office in Brussels[xiii], with the organisational and technical support of the ECAS (*European Citizens Action Service*) and the *Charities Aid Foundation* (CAF) associations. The remit of the Office was to set up links with European institutions, to contribute to the more rapid involvement of Polish asso-

ciations in the work of sectoral networks and NGO platforms at the level of the EU and give them regular information about essential novelties in the work of European institutions, the possibilities of using EU financial support, and the educational opportunities. In preparation is the foundation of such offices for Slovene and Hungarian NGOs, and the same thing is expected for NGOs in other applicant countries.

In spite of the efforts the Union is making to support the development of civil society in applicant countries, most of these countries are characterised by the marked lack of confidence and trust in the relations between the government and the non-governmental sector (EU ECS, 1999). The cause of this is the fact that civil society primarily entered the political dictionary of the lands of CEE as an opposition idea, and is still so considered to a good extent. In addition, the culture of consultation and dialogue, as basic democratic process, is not continuously rooted in the tradition of these countries (Rosenblum, Post, 2002). In the context of the preparations for EU entry, an additional cause for lack of trust is the excessively technical nature of negotiations and adaptation to the Union, which sometimes cast a shadow over the fundamental values of the European integration process. An overemphasis on the standardising and technical aspect of adopting the acquis and neglect of dialogue among citizens are among the main causes of the poor support of the populations of the applicant countries for entry into the EU.[xiv]

CIVIL DIALOGUE IN CROATIA: OPPORTUNITIES AND OBSTACLES

The foundation of the government's Office for NGOs in 1998 turned out to be a key factor in the establishment of trust and the construction of a dialogue between the Croatian government and the NGOs. In the not quite four years of its work, the Office for NGOs, with very limited resources, has contributed to numerous advances in the relations of the two sectors, as well as to an improvement of the state of affairs within the non-governmental sector. Along with constant improvement in the system for financing associations from the national Budget, the most important progress has been made in the adoption of a new, much more liberal Law on Associations in October 2001 (NN 88/2001) and the acceptance of the Programme of Co-operation between Government and Non-Governmental Sector in January 2001.

The Office for NGOs made it possible for the NGOs to take part in the drawing up of both these documents. During the course of preparation for the new Associations Law, the Office, via its bulletin, called for consultation concerning the draft of the Law from 16,000 associations, and for this purpose, special round table meetings were organised at the regional level, attended by local NGOs. The result of this kind of approach was a much more liberal and flexible law, which creates the preconditions for a more powerful development of the non-governmental sector.

The government and NGO cooperation programme is the basic document for the development of civil dialogue and the establishment of consultative mechanisms between the two sectors.[xv] The programme was drawn up subsequent to collaboration and extensive consultation with representatives of NGOs, representatives of local government and self-government, and representatives of government central administrative bodies. The programme, among other things, envisages consultations with the non-governmental sector during the making of new or modification of existing laws and the inclusion of its representatives in the working groups of the proposers of laws, consultation in the process of the drawing up of governmental national programmes and in an evaluation of national policies in all areas. Through this programme the government has bound itself to develop a code of good practice together with the non-governmental sector and to advance the quality of the work through consultations and the evaluation and implementation of policies. The purpose of the co-operation programme is to work not only at a national level, but also at the local levels where most of the associations are active and where it is possible to formulate very concrete guidelines, measures and activities for collaboration between local government and NGOs. One should stress that the process of localising the programme has already started in several Croatian cities (in Split, for example, and Rijeka) and has proved itself to be a firm foundation for a better application of the principle of subsidiarity and for the entire development of civil society in Croatia.

According to recently published research results (Cooper et al., 2002), most ministries (93%) are acquainted with the Co-operation Programme and are building guidelines and recommendations contained within it into their strategies[xvi]. Although an advance in the inclusion of associations into the working groups for the drawing up of given programmes and laws can be noticed, nevertheless very few ministries consider NGOs reliable partners in the shaping of policies. According to this research, a very low percentage of associations stated that they had set up

a real partnership with government institutions, and believed that a real partnership should take for granted a much higher level of information exchange about each party through more frequent and more detailed debates and consultations.

In other recent research (Bežovan, 2001), several problems were highlighted threatening any more successful participation of the organisations of civil society in the process of giving shape to policies. These are the lack of readiness of representatives of the government to pay heed to the problems of the citizens they represent, the weakly developed skills of public advocacy and lobbying, the disinclination of associations to network and coalesce, poor coordination within subsectors, a pronounced absence of any internal democracy within the working of the associations, a low percentage of NGO participation in groups of proposers of laws and in debates about new legislation, and a generally low level of political and civil culture in Croatia.

Poor networking and feeble cohesion within the non-governmental sector is an additional hurdle in the way of the establishment of effective consultative mechanisms. In general, the third sector in the Republic of Croatia is lacking in horizontal information exchange and collaboration. According to results of recent research about cooperation within the non-governmental sector in Croatia (Karzen, Škrabalo, 2001), 80.6% of associations do work together with other associations, but more than 60% of them think that this collaboration is poor. One of the key problems from this point of view is the absence of any forums at which it would be possible to discuss various forms of cooperation and the absence of mechanisms for agreeing about joint action.

In order to encourage joint, partnership-style ways of tackling some of these problems, at the beginning of 2002 the government set up the Civil Society Development Council, an expert and consultative body of the government, composed of representatives of the line ministries, representatives of NGOs and independent experts. The task of the Council was to work on the development, application and effectiveness of the Co-operation Programme, on a strategy for the development of civil society, the development of philanthropy, social capital, relations of partnership and cross-sector collaboration in the conditions of a decentralised decision-making system (NN 26/2002).

In parallel with the establishment of this Council, the government also announced the possibility that the Office for NGOs might turn into a public Foundation for the Development of Civil Society, modelled on those in other countries in CEE. This Foundation would

have as its special role the establishment of strategic cross-sector partnerships and the prompting of a more balanced regional and local development of the non-governmental sector, networking and education. As well as receiving resources from the national Budget, the Foundation would be financed by donations and from income generated by its own activities.

New initiatives are also appearing in the area of the more active participation of NGOs in the legislative process. From the beginning of 2003, the Web pages of the Croatian Parliament should contain the proposals of laws that are in parliamentary procedure. This is the result of a long-term project called *Legislation and the Citizen*, the aim of which is a contribution to the development of a more active relationship among MPs, NGOs and citizens.[xvii] These new communication channels between the NGOs and the legislative arm and its committees is particularly crucial if one takes into account the role that the Croatian Sabor should have in the process of Stabilisation and Association.

THE IMPLEMENTATION OF THE SAA AS POTENTIAL CATALYST FOR CIVIL DIALOGUE IN CROATIA

Evaluating the state of the development of civil society in Croatia in the first published Annual Report on the Stabilisation and Association Process, the European Commission warned of the absence of NGOs in the process of shaping policies and the legislative process, and, in general, of their limited social and political role and influence. In the same part of the report, the Commission reminded Croatia that the success of all-encompassing reforms started out within the context of the implementation of the SAA would depend on collaboration with all social actors and the degree to which civil society was included in the process of European integration (COM/2002/163 final).

As in the previously mentioned examples of candidate states, one of the most important obstacles in the way of the more active involvement of Croatian citizens and NGOs in the decision making about the European integrative processes is their inadequate knowledge of and informedness about this area.[xviii] The Croatian government

recently adopted its Communication Strategy for giving information to the Croatian public about the Croatian approach to European integration[xix], which was prepared in line with similar models in some of the member and candidate states. Although the Communication Strategy cites the NGOs and other subjects in civil society as important target groups and stresses the importance of strengthening dialogues with them, the non-governmental sector is still insufficiently involved in educational and information programmes of the Ministry for European Integration (MEI). This is primarily the result of the MEI's being swamped with the task of educating government officials, and of the overall strengthening of the administrative and institutional capacities to be able to adopt the acquis.

From the very beginning of the implementation of the SAA the governmental administration in Croatia was faced with what must have been the most daunting task to date, for the accomplishment of which all available resources have to be mobilised and powerful cross-sector collaboration has to be established. The implementation plan envisages the adoption of more than three hundred new legislative measures compliant with EU standards by the end of 2006, most of them (80%) during the first two years of the implementation of the Agreement (by the end of 2003). Taking into account the European standards of good governance and the experience of membership candidate states, the Croatian government, in parallel with the strengthening of the administrative and institutional capacities of the administration for the implementation of the acquis, will have to undertake more concrete actions for the active involvement of NGOs in the process of decision making about questions related to Croatian European integration via appropriate formal and informal consultative mechanisms.

Since European integration, unlike many other areas, is still a very uncontroversial topic in Croatia[xx], and bearing in mind that this process will impinge on almost all parts of the political, social and economic life of the country, that it covers practically all sectors in which the associations are active, the implementation of the SAA can be used as a catalyst for the adoption of European principles of good governance, and as a handy base for the reinforcement of the culture of dialogue and the introduction of effective consultative mechanisms between the government and the non-governmental sector.

CONCLUSION

Irrespective of Croatia's lagging behind the countries of CEE that have the status of applicant countries in the process of converging on the Union, the problems that the Croatian government is meeting in the area of building up an effective dialogue with civil society are very comparable with those that the applicant countries have come upon. In spite of the many challenges that can be anticipated because of the establishment of collaboration with the non-governmental sector in the process of European integration, through the work of the Office for NGOs, the Croatian government has achieved a great volte-face in its policy towards the non-governmental sector. The Croatian "Compact" that has been adopted, the Co-operation Programme between the Croatian government and the NGOs, is the kind of phenomenon that is relatively rare even among member states, and is a good springboard for the development of democratic culture and civil dialogue in Croatia. In order for the excellently worked out framework to become everyday practice in the process of adaptation to EU standards that has been started, the government and the non-governmental sector should start looking, as an urgent priority, at their relationship within the broader European context and get involved in more vigorous exchanges of experience with EU member states.

The adoption of new, European models of dialogue and collaboration between government, NGOs and, gradually, the private economic sector would lead to the creation of the preconditions for looking at civil society in the Republic of Croatia not as a separate sector, but as a set of interactive relations among all the sectors and citizens in joint work for public good.

RECOMMENDATIONS AND GUIDELINES

According to everything stated above, it is possible to formulate concrete guidelines and recommendations for the reforms that the Croatian government and NGOs should undertake for the reinforcement of a dialogue within the context of the process of stabilisation and association with the EU. The government should:

- Consider the establishment of formal and informal consultative mechanisms with the non-governmental sector in the process of stabilisation

and association with the EU. The informal model of consultation would be accomplished in the form of conferences, seminars, round tables or forums at which the representatives of both sectors would debate various aspects of the implementation of the SAA. A more formal consultative model could be carried out via working groups for harmonisation of the legislation the constitution of which started in September 2002 for the first 14 (of a total of 31) chapters of the acquis. In line with the objectives of the Co-operation Programme, via its Council for the Development of Civil Society, Associations Office and the MEI, the government should make sure that NGOs, experts for given areas of the acquis, are appropriately represented in the working groups mentioned. The special knowledge and experience of NGOs could turn out to be valuable particularly in the preparation of parallel comparative reports about the implementation of the SAA in selected areas, and for independent impact analyses of the adoption of new legislative measures.

- Via the Office for NGOs and the MEI, it should encourage the more active involvement of NGOs in information and training programmes about European integration. The experience of applicant states shows that only qualified and informed NGO representatives can play a quality role in the process of consultation about adjustments to the EU. Bearing in mind the overload on the MEI with its information and training programmes for government officials, as part of the fulfilment of priority measures for the development of institutional and administrative capacities for the implementation of the acquis, it is necessary to consider the possibility of more active collaboration with distinguished European associations so as to be able to develop information and education activities concerning European integration meant for Croatian NGOs.
- In collaboration with the non-governmental sector, to work out a code of good practice and improvement of the quality of action relating to consultation, evaluation and implementation of policy, in line with the Co-operation Programme. While the code is being worked out, it would be important to make sure its contents are consistent with the general principles and minimum standards for consultation of the European Commission and NGOs, as well as with similar and cognate codes developed in other European states.
- Enable a broadly based Internet access to a database for monitoring the implementation of the SAA, harmonising legislation and the technical assistance programmes via the MEI web page. The availability of the contents of the said bases via the Internet would make for

greater transparency in Croatia's process of adjustment to the EU and would provide an opportunity for a better understanding of the complex and highly technical process of taking on the acquis. This would gradually lead to the creation of the preconditions for launching a project to follow in the footsteps of the European Commission's *Interactive Policy-Making Initiative* that has already been mentioned.
- Consider the Web publication of basic information about existing consultative bodies and working groups of the government in which NGO representatives already are involved, modelled on the European Commission CONECCS base.

The non-governmental associations should:

- Establish more vigorous collaboration and exchange of experience and know-how with associations in the current and future members of the EU. Even before the official launch of the ACCESS programme for Croatia, Croatian associations should set up links with cognate sectoral platforms of NGOs at the level of the EU and get involved in their activities.
- Consider the foundation of an NGO Forum along the lines of those in other countries of CEE, in order to facilitate consultation between government and associations and to contribute to the solution of the problems of fragmentation, incoherence and lack of coordination, the absence of mechanisms for horizontal collaboration and, in general, an inadequate networking and coalition culture within the non-governmental sector.
- Gradually build a European dimension into their strategies and work on the development of knowledge about the processes of European integration so as to be able to grow into important government partners in the process of adjustment to the EU. The leaderships of NGOs should take care of the education of as many of its members as possible, and of the development of internal democracy. Participation in the process of European integration should not become an elitist practice reserved for a restricted group of associations that have the necessary intellectual and financial resources to be able to set up links with similar associations in the EU and to have a better access to education programmes.

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[i] *The concept of non-governmental organisation is not standardised at the EU level. This paper will use alternately the terms NGOs, associations, the non-governmental sector and the third sector as designations for non-profit-making, voluntary, formal, independ-*

ent organisations that work for the general good, not including unions and employers' associations, the traditional social partners (European Commission, COM/2000/11 final; Salamon, Anheier, 1997). In line with the terminological practice in the documents of the European institutions, the concept of civil dialogue will be used to mean the dialogue with the non-governmental sector, as distinct from the social dialogue with the social partners. Although complementary to the civil dialogue and equally important for the development of civil society, the social dialogue is in an institutional and legal sense a distinct case and is not the subject of this study.

[ii] The subject for analysis will be first of all the dialogue of the government and the non-governmental sector in the area of policy development and the legislative process. Other forms of collaboration like the contractual provision of public services and financial support are not covered in this paper. For a more exhaustive review of possible relations of partnership between the government and the non-governmental sector, see, e.g., Newman, C. L. (2000) or Rosenblum, N. L. and Post, R. C. (eds.) (2002).

[iii] The implementation of the SAA, negotiations with the EU, and most of the overall adjustments to EU standards, because of the markedly technical nature, are mostly highly centralised processes in each candidate country and each potential candidate. From this point of view, the examples quoted in this paper will largely be related to the development of civil dialogue at a national level as precondition for successful dialogue between NGOs and the European institutions after joining the Union. Of course, according to the principle of subsidiarity, the standards and general principles of cooperation and dialogue can be analogously applied at a local level as well.

[iv] The concept horizontal has become standard in the European Commission terminology for the policy to the third sector that impinges on traditional vertical sector politics (COM (97) 241 final).

[v] The share of those employed in the third sector, as against all employed in the EU, comes on average to 7.9%. This share is the highest in Ireland and Holland (16%) and lowest in Greece and Portugal (less than 5%), ECOTEC, 2001.

[vi] See the Web page: http://europa.eu.int/comm/secretariat_general/sgc/ong/commun/contributions.htm

[vii] As part of the discussion that the Commission launched about the future of Europe, the aim of which is to prepare EU institutional reform by the time of the next inter-governmental conference in 2004, there is increasing voicing of the demand for the introduction of a legal basis for civil dialogue in a new version of the EU Treaty. For more on this, see the Web page: http://europa.eu/int/futurum/index_en.htm

[viii] See the WWW page: http://europa.eu.int/comm/civil_society/coneccs/index_en.htm.

[ix] The document aroused a great deal of interest among the NGOs, as well as among the governments of member states, which can be seen from the many reactions the contents of which can be seen on the Web page of the Commission: http://europa.eu.int/comm/governance/index_en.htm.

[x] It should be pointed out that the Economic and Social Committee of the EU has put forward a series of criteria to be met by European NGOs if they want to become active participants in civil dialogue at the level of the EU. These are: working permanently at the level of the EU; enabling direct access to the expertise of their members as precondition for rapid and constructive consultation; representation of general interests that tally with the interests of European society; active membership organisation in most of the EU member states; accountability to members; authority to represent and act at a European level; independence and not being bound by any instructions from external bodies; transparency of financing and decision making structures (Economic and Social Committee, CES 357/2002).

[xi] See: http://www.europa.eu.int/comm/enlargement/pas/phare/programmes/multi-

bene/access2000.htm

[xii] *Much more detailed information about the Slovene government project is available on www.gov.si/svez/uk/mainmenu and in Vidacak, 2001, and Van Hulten, 2001.*

[xiii] *For more information, see www.eu.ngo.pl and also www.ecas.org.*

[xiv] *Recent Eurobarometer investigation into public support for EU membership in the applicant countries showed that in half of these countries support for EU entry was less than 50% (from 33% in Latvia to 46% in Czech R). For fuller information see: European Commission, Eurobarometer, 2002).*

[xv] *This programme is a Croatian version of the so-called Compact, the agreement between the government and the non-governmental sector that was originally adopted in the UK at the end of 1998, versions of it being found today in several other countries, such as in France, Hungary and Estonia.*

[xvi] *The provision of Article 27 Paragraph 5 of the Standing Orders of the Government of RC say that ministries, in the procedure for preparing proposals and opinions for the government, should obtain the opinion of associations within whose sphere of competence the questions that are the subject of these opinions and proposals fall.*

[xvii] *This project is coordinated in Croatia by the Croatian Helsinki Committee for Human Rights in collaboration with the international NGO East West Parliamentary Practice Project (EWPPP) of Amsterdam that started the project. Twenty two NGOs from Croatia are included in the work of the project. For more details see www.ewppp.org/lc.*

[xviii] *The results of the last, fifth, wave of research about the attitudes of Croatian citizens to the EU (published 2 August 2002) show 62.8% of Croatian citizens to be in inadequate possession of information about the EU. More about this research can be found on the Web pages of the Ministry for European Integration: www.mei.hr*

[xix] *This document was adopted at a session of the government of 18 October 2002.*

[xx] *According to the most recent public opinion poll in Croatia concerning the process of European integration, the standpoint of most citizens with respect to the EU was positive (78%). The proportion of citizens that supported the efforts of the Croatian government to get Croatia into the EU was very high, and almost unchanged, at 77%. See n. 17.*

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Chapter 12

EQUALITY BETWEEN MEN AND WOMEN: CHALLENGES TO CROATIAN LEGISLATION

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ABSTRACT

Reform of the Croatian legal system and the adjustment of its legislation to EU law is one of the main conditions for the Republic of Croatia to be able to join the Union. This paper analyses the existing requirements for gender equality inside the EU, the current situation in the applicant countries and the existing problems and challenges for states that are only on the way towards European integration. In the Republic of Croatia gender equality is not guaranteed to a sufficient extent, which has resulted in negative public reactions from NGOs and organisations for the protection of human rights and the rights of women. In addition, individuals are exposed everyday to various forms of sexual harassment in the workplace, in schools, universities and public places. So far, except at the constitutional level, no kind of legal approach has been adopted to guarantee gender equality or freedom of sexual orientation, which is an obligation of Croatia according to international treaties and the SAA.

Key words:
gender equality, sexual orientation, equal opportunities principle, equal procedure principle, sexual harassment, European Union, Copenhagen criteria, Council of Europe, Stabilisation and Association Agreement, European Community Treaty, acquis communautaire.

INTRODUCTION

The protection of fundamental human rights is both a challenge and the most important objective in the construction of a modern and democratic society. Many European states, in the endeavour to acquire the description of being democratic have put provisions about gender equality into existing laws or have passed special laws protecting sexuality and fundamental human rights such as the right to life, liberty, privacy and dignity. In spite of this, in most of them sexual harassment is still not regulated by special legal provisions, i.e., laws.

The conditions for joining the EU are clear and precise. States that are applicants for membership and future associated members have a laborious task ahead of them in fulfilling these really high criteria, which also means adjusting the national legislation with the rules of the EU. What conditions for membership are and what kind of framework the EU has set up for future members is explained in Chapter 2.

Through comparative analysis (in Chapter 3) of the existing situation in some of the member states, states that are applicants for membership of the Union and the less developed current members, an endeavour is made to highlight the existing level of protection of gender equality and victims of sexual harassment at a European level. Chapter 4 deals with the current level of legal protection in the Republic of Croatia and says how much the Republic of Croatia is behind in the process of coming closer to the EU.

At the end, with concrete conclusions and recommendations of measures to bring Croatia closer to the standards for membership in the EU (Chapter 5), the necessity for reform in Croatian legislation and its adjustment with EU law is highlighted.

THE EU AND GENDER EQUALITY

The criterion for the protection of gender equality

Equal treatment of the sexes, one of the fundamental human rights, is protected at the level of the Union. One of the criteria for

the protection of fundamental human rights in the EU legal system is the European Convention.[i] The European Court of Justice is bound to protect these rights. Although the EU is not a party to the EC, the European court has started to apply its rules (Rodin, 1997). This means that parties to the EC (member states of the Council of Europe) are obliged to ensure that its rules are really applied.

States parties of the EC can ensure the application of the Convention-guaranteed rights by ratification of the EC[ii] and its direct application as a *self-executing* treaty, through the passing of a separate legal instrument to incorporate the rights guaranteed by the EC into the domestic legal system, or else the state can decide that the degree, and the content, of the protection of human rights is, at a national level, already in accord with the standards stipulated by the EC. The Constitution of the Republic of Croatia says that international treaties[iii] that have been ratified and published are applied directly and have a force superior to statute. Since the standards of the EC, depending on national law, will be self-executing, i.e., directly applicable, and since the Croatian Constitution allows for this, the courts and other bodies in the Republic of Croatia can apply them directly (Rodin, 1997).

As a result of the change that occurred when the Treaty of Amsterdam (1999) came into force, the principle of the equality of men and women was supplemented in the broader context by the application of the so-called positive measures. The application of positive measures was envisaged in Article 2 of the Treaty according to the Directive on the implementation of the principle of equal treatment for men and women as regards access to employment, vocational training, promotion and working conditions (207/76/EEC) and the Recommendation of the Council (84/635/EEC) on the promotion of positive measures with respect to women. The European Court of Justice defined positive measures as obligatory and justified. The Amsterdam Treaty confirmed the importance of the principle of equal opportunities, and of the respect for human rights in the integration process. Certain legislative additions were passed to open up new opportunities for advancement as were Union objectives, including the most important one – the promotion of equality. They guarantee a high level of social protection and employment, equality of men and women, improvement of conditions and quality of life and mutual economic and social assistance among the member states. All the same, this article says nothing about actual equality, that is, the

putting into practice of the principle of equality. According to Article 13, the Council is obliged to undertake all measures against discrimination. Discrimination according to gender is just one of the segments governed by this article. Its provisions will not come into force until directives about what its substance is are adopted. Article 137 of the EC Treaty obliges the Community to support member states in the area of the promotion of equality between men and women in equal job opportunities and conditions of work. Article 141, the most important provision of the EC Treaty, gives a legal basis to the positive action measures, raising them to the level of the constitution of the Community. The implementation of these measures is made possible by Directive of the EU Council no. 75/117/EEC concerning the approximation of the laws of member states that relate to the implementation of the principle of equality of pay for men and women.

In the Council's Recommendation no. 84/635/EEC, which is based on the idea of equal opportunities, it is concluded that the promotion of this principle is only possible with the work of the member states and with their cooperation in the bodies that carry out social policy (the social partners). In its preamble it confirms the fact that the traditional anti-discriminatory measures are inadequate for the obviation of the existing inequalities. The recommendation pays special attention to the fact that the public sector could do a lot in this direction and in this way serve as a model in the solving of the same problems in the other areas. The Council recommends member states and social partners to adopt and apply positive measures. In this manner, although the Recommendation has no legally binding force, important steps can be made in the promotion of the principle of equality, for which, of course, two-way cooperation between state and individual is required (Rubenstein and De Vries, 1998).

In the rectification of existing inequalities, the legally binding and the not legally binding documents at the level of the Union are equally essential. For example, the EU Charter of Human Rights, though it has no legally binding status in the legal system of the Union, does nevertheless have marked importance in connection with the respect for and promotion of the principle of equality. Thus in Article 21 of the European Charter, all discrimination on the grounds of gender, race, skin colour, ethnic and social origin, genetic features, language, religion and convictions, political and other opinions, affiliation to some ethnic minority, wealth, birth, disability, age or sexual orientation is forbidden. In spite of the Charter's having created no new

legal resources capable of being used in the protection of human rights in the member states of the Union, it has a powerful interpretative force. The courts of the member states and the European Court must pay attention to it in their interpretations and interpret legal norms in the light of the rights guaranteed by the Charter. Such practice, which is otherwise accepted in the judicial interpretation of international law, starts off from the assumption that the national and European legislation did not in its activity have any intention of breaching any of the provisions of the Charter, rather to follow them. Although it is not part of the positive legal system of the EU, the Charter has already had certain legal impacts mediated via the interpretations of the courts (Rodin and Selanec, 2001). Similarly, Croatia is not obliged to incorporate the guarantees contained in the Charter into its legal system. Nevertheless, considering the conditionality of the Agreement on European standards of protection of human rights being respected, the Charter will have to be a criterion for normative regulation and protection.

The EU requirements and the harmonisation of the national legislation with EU law

The process of integrating new states into the EU takes for granted the existence of mutually different legal and political systems, which in a given period and according to certain agreed on institutional solutions will tend to converge on each other so that in the end their integration will become a merely formal question (Rodin, 1997). It is a question in this how much total integration of the new states is a matter of international and internal policy of the member states and how much a legally regulated process. The course of integration and final joining of the Union are conditioned both procedurally and substantially. Experience to date shows that the states that have become members have previously gone through various phases of contractual regulation of their relations with each other. The transition from one phase to another is today a matter of the political evaluation and will not only of the member states, but of the European institutions as well.

When there is discussion of the integration of the countries of Central and Eastern Europe into the legal system of European law, one of the basic problems is the question of the harmonisation of their

constitutional law systems and their ability to integrate. The principle of the equality between men and women, or equal treatment in line with the provisions of the Treaty on the foundation of the European Community (Article 141), with the Draft Charter of the EU on fundamental rights, and Directive EU 75/117/EEC about harmonisation of the laws of member states that relate to implementation of the principle of equality of pay for men and women, the Council's Directive EU 97/80/EEC about the burden of proof in cases of discrimination on grounds of gender, EU Directive 76/207 on the implementation of the principle of equal treatment for men and women as regards access to employment, vocational training, promotion and working conditions. The article of the Foundation Treaty mentioned is binding upon all member states of the EU and constitutes a law with which Croatian law will have to become harmonised. It is also the legal basis for the passing of the secondary legislation the reception of which is also part of the acquis, and hence a condition for approaching the EU.

In accordance with everything stated, it is the duty of the Republic of Croatia to ensure the creation of regulations guaranteeing equality between men and women, freedom of sexual orientation, and protection from various forms of sexual discrimination, especially of sexual harassment. This would also be to create the grounds for the harmonisation of Croatian law with EU law, the passing of bye-laws and regulations, collective agreements and so on.

THE EQUALITY OF MEN AND WOMEN

Equality between men and women at the level of the EU

The Equal Treatment Directive forbids every form of discrimination, direct and indirect, on the grounds of gender. At the same time, its aim is to give legal form to the principle of equal treatment for men and women. The equal treatment directive contains three exceptions to the principle of equal treatment (De Burca and Craig, 1998). These are of limited opportunities for derogation, the application of positive measures, and the removal of existing inequalities that most of all hit women because of their abilities to get employed and promoted, to receive further training, their working conditions and social security.

The states have also bound themselves to introduce more effective sanctions and damages in cases of sexual harassment and the introduction of a special counsellor or commissioner for the prevention of sexual harassment at the workplace. Still, in its form to date the directive has not sufficiently thoroughly regulated the problem of direct and indirect discrimination, sexual harassment[iv], the questions of sanctions and damages, the foundation of special bodies in the member states to promote the principle of equally opportunities and the questions of parental rights while seeking maternity leave, and in line with this the Council and the Parliament have decided on joint action to draw up a proposal for a draft amendment to the said instruction.[v] The final wording of the amendment has still not been adopted because of the long-lasting procedure through which it has to go in the EU institutions. If these amendments are accepted in their existing form, it will be an important advance in the development of the existing legislation at the level of the EU that protects equality between men and women. The Commission has proposed that a more precise and all-embracing definition of sexual harassment be put into the final wording of the amendment. In favour of this is the fact that a small number of men, but no less significant, complain of sexual harassment at work from women and other men, that is, it is not only women that are the victims of sexual harassment, and men are not the only perpetrators. Young women, women starting out at work, women with irregular and insecure labour contracts, women who carry out traditional jobs, divorced women, lesbians and women who are members of minority racial and ethnic groups are particularly exposed to sexual discrimination (Rubenstein and De Vries, 1998).

In the Council's Resolution on the protection of men and women at work and in the European Commission Code of Practice on Measures to Combat Sexual Harassment various forms of conduct that are considered sexual harassment are stated (Rubenstein and De Vries, 1998). Sexual harassment is absolutely unacceptable if it implies conduct that offends the other person, if it is undesirable and unjustified; if the rejection of or submission to such conduct – whether it is a matter of working women or employers (including superiors and equals) is directly or indirectly used while making a decision about taking someone on for practice or a job, about the offer of a permanent job, about promotion, a pay rise, of if it affects any kind of decision about employment and if such behaviour makes the work environment inimical, awkward and degrading for the person it applies to.[vi]

Equality of men and women in some EU member states

In an analysis of the EU average to date about the normative level of protection of gender equality we will have to make use of an individual approach to the study of the existing legislative solutions in each one of the member countries. This is a lengthy business because of the variety of solutions, with respect to their contents, the scope of the protection and the way it is applied. Provisions about the equality of men and women and about sexual harassment are built into various already existing laws, such as labour laws, criminal codes and other regulations – collective bargains and labour contracts. The battle against sexual harassment at the EU level has in recent years resulted in provisions about sexual harassment being put into existing laws in countries like Belgium, France, Germany, Italy, Ireland, Holland and Spain and into collective agreements in some sectors, as in Spain, the UK, Holland and Denmark. This is also the duty of states according to the European Commission's Recommendation on the Protection of the Dignity of Women and Men at Work (92/131/EEC).[vii] In some states provisions about gender equality have been put into special laws such as equal treatment laws or equal opportunity laws. What is common to them all is that all states are protecting sexuality at the level of constitutional law. Through a review of existing legislative approaches in some of the member states we can define the current average protection of the rights of individuals from sexual discrimination.

In the establishment of actual equality, *Sweden* is, of course, among the leading countries. The *Sweden or Nordic model* stands out as one of the most progressive models in the promotion and protection of sexual equality.[viii] The Nordic countries have the institution of Ombudsman for matters of encroachment on the equality between men and women. The equality of the sexes is governed by a special equal opportunities law which guarantees an equal position to men and women, that is, it protects them from every form of discrimination related to conditions of work, equal pay for equal work, retirement conditions, parental relations, sexual harassment, and equal representation of men and women wherever it can be achieved. The Equal Opportunities Act expressly forbids sexual harassment at the workplace, sexual harassment by an employer or some other employee, and every form of harassment that is the consequence of a report by an employee who has

been the victim of sexual harassment to the competent body. An employer who infringes the provisions of this law is bound to pay damages. The objective of the law is to achieve the non-condemnation of any person who has at work complained or agreed to testify in the case of some complaint (Elman, 1996). It is important to mention that in Sweden there is also a Ministry for Matters of Gender Equality (Kindenberg, 2001).

In France and Germany the application of the criminal code is one of the main resources in the battle against sexual harassment at work. In *France* sexual harassment was recognised as a problem as far back as 1985, an important role being played by the European Community (Elman, 1996). The Recommendation and the Regulations of the Commission had the biggest part to play in this. In French law sexual harassment is incorporated into criminal, labour and civil law. In spite of this, existing approaches are still subject to criticisms because it is considered that the provisions in force to do not sufficiently protect the victims of sexual harassment. This is a particular problem in the workplace, where sexual harassment mostly actually happens.

EU member countries mostly follow the American model when passing provisions about sexual harassment. The *Austrian* Equal Treatment Act contains provision about sexual harassment along the lines of the American rules (*Equal Employment Opportunities Commission Guidelines*). The Act also covers all forms of sexual harassment (Cahill, 2001). The Equal Treatment Commission is charged with handling complaints about sexual harassment.

The situation in the *UK* is similar; an increasing number of various forms of sexual harassment of heterosexual and homosexual men and women forced the government there to set up a special Equal Treatment Commission in England, Scotland and Wales, to provide for individuals efficient legal protection against various forms of sexual harassment. The legal basis for the handling of complaints is the Sex Discrimination Act passed in 1975 (Millins and Bridgeman, 1998). In addition, the implementation of the rules concerning sexual discrimination put in this law was influenced by the European Commission's Recommendation and Code of Practice on Measures to Combat Sexual Harassment.

France and Belgium[ix] have the most complete regulations about protection against sexual harassment, with *Holland and Great Britain* not far behind, while *Greece and Portugal* do not have any special regulations at all to regulate the ban on sexual harassment.[x] This, of course, calls into question the protection derived from and respect for the princi-

ple of gender equality guaranteed in the constitutions of the states mentioned. Although victims of sexual harassment and other forms of the infringement of the principle of equal opportunities and equal treatment can seek protection of their rights at the constitutional and international level, there is still the problem of the absence of any regulations to regulate questions of damages and determine sanctions in such cases.

Equality between men and women in countries that are applicants for EU membership

Research into the current legal protection against sexual discrimination in states that are applicants for membership in the EU shows that most of them are still not ready for EU accession. The criteria of respect for high standards of protection of fundamental human rights and liberties are truly high, and are also important for the establishment of and respect for the democratic principles that each state should aim at. Apart from that, it is also their duty if they wish to be full members of the international community and of supranational institutions such as the EU.

Slovenia has passed its Workplace Relations Law, which came into force in 1998. The Law explicitly forbids the discrimination in the workplace of persons who are inclined towards the same sex. An employer is expressly forbidden to put any employee into an unequal position because of his or her ethnicity, race, skin colour, sex, age, state of health, religious, political or other conviction, membership in a party, ethnic or social origin, family and health status, sexual orientation and other reasons of a personal nature. Since 2001 there has been an ombudsman for human rights. This progress by Slovenia in the protection of the principle of equality and the suppression of discriminatory behaviour of homosexual or bisexual orientation was positively evaluated by the European Commission (Pecnik, 2002). In spite of this, the European Parliament, the Council and the parliaments of the member countries set Slovenia two more conditions in the area of protection of sexual equality which it is bound to meet before it can join the EU. These concern the need to adopt a national programme for protection against discrimination, and the application of such a programme in practice.

The EU has also given a positive evaluation of the advances made in the protection of equality between men and women in *Estonia*,

where the constitution bans various forms of discrimination, including discrimination on the grounds of gender. Such forms of discrimination are forbidden in the Salaries Law and the Labour Law. Apart from this, the national programme for the adoption of the acquis guarantees the passing of a gender equality law by the end of 2002. This programme will also settle the problem of sexual harassment at a legislative level.

The *Czech Republic* has to thank the existence of a constitutional provision about the equality of men and women for its advances in the protection of gender equality and a positive evaluation of the current situation. From the examples of the Czech Republic, Estonia and Slovenia it is obvious that some of the applicant states have fulfilled a large number of the conditions to join the EU, thus approaching high standards for the protection of human rights. As against this, most of them are still faced with extensive work in the creation of a new legislative background for the protection of equality between men and women.

In *Bulgaria*, discrimination on grounds of gender is explicitly forbidden by the Constitution and the Labour Law. In spite of this, women are still exposed to gender discrimination at the workplace, which means that the rules prescribed by the labour law are not put into practice and are not respected. Employers often break the rules about equal opportunities, the rights of women to maternity leave, and do not adequately protect women from sexual harassment at the workplace. Apart from that, the current Bulgarian labour law does not contain the principle of equal pay for equal work, which existed in the Bulgarian Labour Law up to 1992. Since then women have no longer been guaranteed this equality and in reality they are considerably worse paid for their work than men. Apart from that, the legislator has failed to regulate the matter of legal remedy and damages in all cases of sexual discrimination and sexual harassment. Nor does the Bulgarian criminal code anywhere specifically mention the problem of sexual harassment, although there are several provisions that refer indirectly to cases of sexual discrimination. Still, these provisions do not protect the victims of sexual discrimination at the workplace. In Bulgaria there is no special commission to which complaints could be sent in cases of violation of the principle of equal opportunities, equal treatment and sexual harassment. Sexual harassment is not specifically regulated by a single law or regulation. For this reason Bulgaria has been exposed to EU criticism (and international criticism too) because of its failure to respect its own constitutional principles and laws, by which it is in breach of the obligations it has undertaken to join the EU.

Malta, Romania, Cyprus, Slovakia and *Turkey* do not meet in their entirety the criteria of the protection of equality between men and women. Since these are all states that ought to be acceding to the Union in the next round of enlargement, they have a really difficult task to harmonise domestic legislation with EU law, and to meet the now rather high criteria that have been set by the current member states in the matter of the regulation of gender equality.

EQUALITY BETWEEN MEN AND WOMEN IN CROATIA

Croatia does not currently satisfy all the criteria for membership of the EU. Apart from the 1993 Copenhagen criteria, the Republic of Croatia still needs to meet the additional political conditions relating to the return of refugees, media freedom, cooperation with the ICTY and regional cooperation. As part of its reporting on whether Croatia has lived up to the provisions of the SAA, the EU is also monitoring whether it meets the criteria for EU membership. In this area, for us the most important criterion is that of stability of institutions of the member countries sufficient to ensure democracy, the rule of law, the respect for human rights and minority rights. Croatia is still quite a long way behind in fulfilling these criteria, especially because of the lack of proper laws to protect the right of individuals at the normative level, because of the ineffectiveness of the courts, and because of the inadequate number of properly educated experts (especially lawyers, most of whom who do not know the material of European law). For this reason we have no reason to hope for any rapid approach to the standards for membership in the EU.

Still, the Republic of Croatia has made a certain advance in the regulation of the equality between men and women at a legislative level. The amendments to the Labour Law of 2001 put in a provision concerning positive discrimination. There was also an intention to adopt a provision about sexual harassment, but for reasons of absence of political will, it was left out. No provision about sexual harassment exists in the Criminal Code either. The provisions of the Criminal Code define abuse and do not make any distinction between abuse and harassment. What is positive is that in some firms there is a trend towards putting rules about sexual harassment into the collective

agreements, because of the increasing number of complaints from individuals (mainly women) that they had been exposed to some form or other of sexual harassment at the workplace. This is in line with the Rules of the Commission about practical measures for suppressing sexual harassment of 1991, and with the Commission's Recommendation of 1991 concerning the protection of the dignity of men and women at work. Although these are not obligatory, states that are applicants for potential membership of the EU are bound to follow them in the process of harmonising the national legislation with EU law. Croatia too took on this obligation when it signed the SAA. The Republic of Croatia also bound itself to respect the norms of international law, and this obligation derives from the constitutional provision according to which international laws that have been ratified and published are ipso facto a part of the internal legal system. The existing constitutional framework of the Republic of Croatia does not have any major drawbacks that would prevent the country joining the EU. The final arbiter in the area of the protection of fundamental constitutional rights and liberties in the Republic of Croatia is the Constitutional Court. Just like the practice of this body, Croatian legislation too accepts the solution according to which it is held that the degree and contents of the protection of rights in a material sense at a national level is in line with the standards stipulated by international treaties. Nevertheless, in practice it turns out that any victims are deprived of their rights, because the national courts apply in their proceedings only the statutes and usually ignore the standards laid down in international documents, which is one of the limitations in the process of approaching the EU. It is obvious that certain adjustments of the standardising system will be needed; they can be done either through legislative regulation (the most likely approach), or through interpretations of the Supreme and the Constitutional courts. The choice between these two approaches will certainly depend on the mood of the political body (Rodin, 1997).

Judging from the speed at which applicant states have progressed towards membership to date, it is realistic to expect that the Republic of Croatia at its current tempo could in a year or two approach the criteria set up for EU accession. In this process, the Republic of Croatia should take account of any external risks that could constitute a limitation on its rapprochement with the EU. They could result in changes in the EU attitude to Croatia, and also on an insistence on the achievement of legal protection standards that Croatia is not capable of meeting because of the current limitations within the

domestic legal system. At the moment Croatian institutions are not prepared for this process, and it is unreal to expect that the problem will soon be able to be solved. It is practically impossible to estimate when the Republic of Croatia will really and fully, in the sense of the respect for the respect for human rights, be ready to become a fully member of the EU. This will depend quite a lot on the development of the awareness of the individual of the need to protect people against discrimination on grounds of gender and sexual orientation, and on political will to have an impact on the acceleration of the adoption of legislative solutions protecting the sphere of sexuality.

CONCLUSIONS AND RECOMMENDATIONS

In the regulation of equality between men and women and protection from sexual harassment, as already mentioned, Croatia is not essentially behind the current applicant states, because some of them have still not put sexual harassment provisions into their existing laws (e.g., Romania, Slovakia and Turkey).

Nevertheless, we do lag behind the member countries, and for this reason further efforts in the adjustment of the national law to solutions that already exist in the member states (for example, in the UK, France, Sweden and Austria) are necessary. By taking over existing solutions, a point of departure is created for further regulation of the question of gender equality and protection against sexual harassment. Before this it is necessary to work out an effective strategy of and directives for the harmonisation of the national law. Bearing in mind the criteria of protection of human rights, it is certainly necessary to forbid in Croatia both direct and indirect discrimination on the grounds of gender and sexual orientation; to guarantee equality of men and women in all areas, particular with respect to employment, work, pay, promotion and further training; to guarantee equal pay for equal work, or work of equal value; to guarantee the equality of men and women in the area of social security; to bring in measures of affirmative action; to guarantee freedom of sexual orientation and to ensure court protection and damages in all cases of violation of the right to equality between the sexes. The legislator must decide in which way it will apply these solutions, perhaps through the passing of a single law which will set rules about various forms of discrimination on grounds of gender or sexual preference, or perhaps such provisions can be inserted into laws

that exist already (e.g., the Labour Law, the Civil Law, the Criminal Code, the Family Law). One of the recommendations must certainly be the insertion of provisions forbidding sexual harassment into the Criminal Code *de lege frenda* with a contemporary provision modelled on American law, from which the term *sexual harassment* is actually taken.

The objective of putting provisions about equality between men and women into the Croatian legal framework is to introduce standards for the identification of various forms of discrimination with respect to gender and sexual preference, and mechanisms for its obviation, including the protection of the courts. Respect for the criterion of equality between men and women and legal protection against sexual discrimination is one of the areas of the most dynamic development of European law. Hence for the Republic of Croatia it is exceptionally important to keep up with the changes and to make up for the existing gap. Founding a special independent body to which complaints about sexual discrimination and infringements of the principle of equality between men and women and the drawing up of a national programme for the battle against sexual discrimination would certainly speed this process up.

At the end, it is important to draw attention to what is perhaps the most important step – sensitising the domestic public to the existence of a problem. This would be greatly helped by a high quality media campaign. Women's associations should present their work and its effectiveness better, and not monopolise the area, in the sense of claiming that they alone are competent to solve questions of violations of equality between men and women. All of this is a long-lasting and extensive process, in which all the experts and legal institutions of the Republic of Croatia have to be involved.

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[i] *According to Article 14 of the Convention (a general clause) the exercise of the rights and liberties acknowledged in the Convention has to be secured without discrimination on any grounds at all, with respect to gender, race, colour, language, religion, political or other opinions, ethnic or social origin, affiliation to an ethnic minority, wealth, family or any other grounds. This article is not applicable without the invocation of the breach of some other right. For the more effective implementation of the principle of equality and the protection of human rights, the Committee of Ministers, on 26 June 2000, adopted Protocol 12 (the Republic of Croatia ratified this, but it is not yet in force), which guarantees a general prohibition of discrimination, in line with Article 14 of the Convention.*

[ii] *The Republic of Croatia signed the European Convention on 6 November 1996, and ratified it on 17 October 1997. It deposited ratification documents on 5 November, and it was subsequently published in Official Gazette 18/97, annexe: Treaties (Rodin, 1998).*

[iii] *Fundamental human rights are protected by international documents like the General Declaration of the UN concerning the rights of man, the International Pact on Civic and Political Rights, Convention relating to discrimination to do with employment and occupations, the Charter of the Community concerning the basic social rights of employees, the Convention on the elimination of all forms of discrimination against women, the European Convention and the European Social Charter. The principle of equal treatment was originally contained in the character of the ILO, whence it was put into the Philadelphia Declaration (1944).*

[iv] *The concept of sexual harassment started to be mentioned in the mid-70s in America, when the feminist movement started up, and hence many ascribe its appearance to the feminist schools that came into being at that time (MacKinnon, 1987).*

[v] *The Commission for the first time announced a proposal to amend the existing Directive on 7 June 2000, aiming at its improvement and creating standards concerning sexual harassment. The EP in the second reading of the draft of the bill for the modified Instructions proposed several amendments to the wording that the Council sent it in July 2001.*

[vi] *The Regulations of the European Commission about practical measures for the suppression of sexual harassment distinguish two kinds of sexual harassment: sexual extortion (quid pro quo) and sexual harassment brought about by a hostile environment. Both expressions are taken from American literature (MacKinnon, 1987).*

[vii] *The basic definition of sexual harassment derives from the American Equal Opportunities Commission (Cahill, 2001). Sexual harassment is regulated in most detail in US law, more precisely, but Article 14 of the Constitution, the Civil Law of 1964 (Ch. VII, section 703) and practice of the Supreme Court (the best-known case of sexual harassment to have appeared before the Supreme Court is Meritor Savings Bank v. Vinson iz 1986).*

[viii] *One of the basic reasons for Sweden to have made such progress in the promotion of gender equality is the change in the basic approach to the understanding of equality. What was changed in the Swedish way of understanding gender equality is the evolutionary approach. The fundamental unit of society is not the family but the individual, hence a woman, as individual, is acknowledged to have the same rights as a man.*

[ix] *In Belgium the Labour Law was augmented by an amendment about regulations at work, and employers are obliged to undertake measures to protect employed people from sexual harassment at work.*

[x] *It is appalling that about 50% of European women claim to have been the victim of sexual harassment (Rubenstein and De Vries, 1998).*

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GLOSSARY

ACCESSION PARTNERSHIP – the main instrument for the pre-accession strategies of the applicant countries and the EU. Its purpose is to determine the priorities and the necessary financial assistance for each area during the harmonisation of it to the legislation of the Union. Each country has to work out a detailed programme for the application of the acquis, determine the timetable for assignments, and the human and financial resources necessary.

ACQUIS COMMUNAUTAIRE or COMMUNITY ACQUIS – the body of rights and obligations that binds and links all the Member States in the EU. It does not cover only laws in the narrow sense, but also the common objectives laid down in given founding treaties. Each country that wishes to become a member of the EU has to accept the decisions in the foundation treaties and adjust its legislation with the community acquis.

AGENDA 2000 – a document of the European Commission containing a programme of activities related to the development of the EU and the financial framework for enlargement with the new Member States in the period 2000-2006.

ASSOCIATED COUNTRIES – countries that have signed an associated membership agreement, that is, the Central and Eastern European applicant countries.

ASSOCIATION AGREEMENTS, EUROPE AGREEMENTS – a special form of association agreement between the EU and separate countries of Central and Eastern Europe and the Baltic countries. The basic objective of an agreement is the preparation of the associated countries for EU accession. It is based on the principles of respect for human rights, democracy, the rule of law and the market economy. Europe Agreements have been signed with ten countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

CARDS (Community Assistance for Reconstruction, Development and Stabilisation) - a new programme of EU technical and financial assistance for South East Europe (beneficiary countries: Albania, Bosnia and Herzegovina, Croatia, Federal Republic of Yugoslavia and

FYR Macedonia), meant for the implementation of the stabilisation and association process. CARDS priorities are: reconstruction, the return of refugees and displaced persons, the stabilisation of the region; the establishment of the institutional and legislative framework (democracy, human rights, rights of minorities, reconciliation, civil society, media independence, the fight against organised crime); sustainable economic development and economic reform oriented towards a market economy; social development; cross-border, trans-national and regional collaboration.

CENTRAL EUROPE FREE TRADE AGREEMENT, CEFTA – the basic objectives of CEFTA are the harmonisation of the development of economic relations among the states signatories, the raising of the standards of living and the ensuring of better employment opportunities, increasing productivity, a rise in financial stability and the removal of trade barriers among the signatories. CEFTA created one of the preparatory activities on the way to full membership in the EU. In December 1992 the Agreement was signed by the then Czechoslovakia, Hungary and Poland; in 1996 by Slovenia, in 1997 by Romania, and in 1999 Bulgaria. Croatia signed a CEFTA Accession Treaty on 12 December 2002, and it is expected that Croatia will become a full member during 2003.

COMMON AGRICULTURAL POLICY, CAP – its objective is to provide reasonable prices of agricultural products for European consumers, appropriate incomes for farmers and the application of the principle of single prices, financial fairness and a preferential approach to EU agricultural products. It is one of the most important common policies of the EU, and about 45% of the EU budget is spent on its implementation.

COPENHAGEN CRITERIA, ACCESSION CRITERIA – principles and criteria laid down at a meeting of the European Council in Copenhagen in 1993. The heads of Member States of the EU agreed that it would accept the countries of Central and Eastern Europe as members if they meet these political and economic criteria: (1) stability of institutions to ensure democracy, the rule of law, the respect for human rights and the rights of minorities; (2) respect for an effective market economy and (3) ability to assume the obligations that derive from the acquis, including the implementation of the political, economic and monetary objectives. The EU retains the right of decision as to when it will receive new members.

COUNCIL OF EUROPE – an intergovernmental organisation that encourages in the member countries the development of democracy, respect for human rights, the rule of law and promotes the European cultural heritage. The Council of Europe was set up in 1949 by ten European countries (Belgium, Denmark, France, Ireland, Italy, Luxembourg, Norway, Netherlands, UK and Sweden) and has today 43 members. All members of the EU are also members of the Council of Europe, which is headquartered in Strasbourg.

COUNCIL OF THE EUROPEAN UNION (often cited as the Council or the Council of Ministers in the texts) – the most important decision-making body of the EU. The members of the Council are the line ministers of the 15 states members, who meet according to the topics: for foreign policy, agriculture, industry and so on. Irrespective of the varying sectoral composition of the ministers of the Council, depending on the topic being debated, the Council works as a single institution. Each Member State chairs the Council for six months. According to the Amsterdam Treaty, the secretary general of the Council also acts as the high representative for the common foreign and security policy. In the institutional triangle of the Union (the European Commission, the Council of the EU and the EP), the Council represents the Member States.

ECONOMIC AND MONETARY UNION, EMU – the process by which Member States of the EU harmonise their economic and monetary policies with the ultimate aim of adopting the single currency, the euro. The Maastricht Treaty completely developed the objective of monetary union, the method and timetable for its creation. The European Central Bank is charged with the implementation of European monetary policy; since 1999 it has fixed exchange rates and introduced the common currency. From January 1991 on, the EMU had 11 members, and Greece joined in 1993. The common currency was not adopted by three Member States: Denmark, Sweden and the UK.

EUROPE AGREEMENTS → ASSOCIATION AGREEMENTS

EUROPEAN CENTRAL BANK, ECB – administers the European central bank system, its task being to determine cash flows, manage foreign currency transactions, manage the official foreign currency reserves of the Member States and look after orderly payments clearing. It was founded on 30 June 1998, when it took over the responsibility for implementing European monetary policy.

EUROPEAN COMMISSION – the executive body of the EU charged with initiatives, the implementation of the founding treaties, governance and control. It is composed of 20 members (two each from France, Germany, Italy, Spain and the UK, and one each from the other countries). Members of the Commission are agreed on together by the Member States, and they are confirmed by the European Parliament, to which the Commission is answerable. The period of office of the Commission members lasts for five years. Within the context of the institutional triangle of the Union (the European Commission, the Council of the EU and the European Parliament), the Commission represents the European Community.

EUROPEAN COMMUNITY – an expression that used to be used unofficially (until the negotiations concerning the European Union) as a common term for all three communities: the European Coal and Steel Community, laid down by the 1951 Treaty of Paris, the European Economic Community (EEC) and the European Atomic Energy Community (Euratom), founded in Rome in 1957. In official EU communications all these three communities are referred to in brief as the Community.

EUROPEAN COUNCIL – a concept that arose in practice, and was then founded by the Single European Act (1986). The heads of states or governments of the Member States of the EU meet at least twice a year with the president of the European Commission in order to debate questions essential for the EU.

EUROPEAN ECONOMIC AREA, EEA – created in 1992 by an agreement signed by the then 12 Member States of the European Commission and EFTA for the sake of the creation of a single market in which the freedom of the movement of people, goods, services and capital would be respected. Today the EEA consists of 18 states: the 15 states of the EU and the Member States of EFTA (Iceland, Liechtenstein, Norway). In the EFA area, about 80% of the regulations of the single EU market are applied.

EUROPEAN EMPLOYMENT STRATEGY, EES part of the wider political programme that the Union set off in 1997 in Luxembourg, and confirmed in Lisbon in 2000, the aim being to create an EU that is the most dynamic and most competitive region in the world and to encourage greater employment and social cohesion.

EUROPEAN FREE TRADE ASSOCIATION, EFTA – an international organisation uniting the markets of Iceland, Liechtenstein, Norway and Switzerland into a free trade zone that is at the same time a platform for the participation of its three members (not including Switzerland) in the European Economic Area together with the 15 states of the EU. EFTA was founded by the Stockholm Convention of 1960 as an alternative to the EEC as it then was.

EUROPEAN MONETARY SYSTEM – an agreement by which the Member States of the EU linked their currencies so as to avoid great fluctuations in exchange rates and inflation. This monetary system, founded in 1979, was the forerunner of the Economic and Monetary Union.

EUROPEAN PARLIAMENT – the representative body of the inhabitants of the EU. Members of this Parliament have been chosen by direct ballot since 1979; the number of members chosen in a given Member State is in proportion to the population of the country as a share of the total population of the EU. The EP currently has 626 members, and its remit includes: consideration of the proposals of the European Commission, participation in the adoption of regulations, appointing and discharging members of the European Commission, the right to queries related to the work of the European Commission and the Council of the EU, division of authority in the adoption of the annual budget and supervision (with the Council) of the execution of the budget. In the institutional triangle of the Union (the European Commission, the Council and the European Parliament), the Parliament represents the citizens of the Union.

EUROPEAN UNION, EU – a supranational community created as a result of collaboration and integration that was started in 1951 by six countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands). After more than 50 years and four waves of enlargement (1973, Denmark, Ireland and the UK; 1981, Greece; 1986, Portugal and Spain; 1995, Austria, Finland and Sweden), the EU today has 15 members. The title of European Union was introduced in the European Union Treaty of Maastricht (1992). The first pillar of the EU consists of the three communities: the European Coal and Steel Community, the European Economic Community and the European Atomic Energy Community; the second pillar is its common foreign and security policy; and the third is collaboration in matters of justice and internal affairs.

EVOLUTIONARY CLAUSE – a formulation from the Stabilisation and Association Agreement. In it, a state that starts the association process expresses its intention to join the EU, and the EU accepts this.

EXCHANGE RATE MECHANISM, ERM – the germ of the Economic and Monetary Union. This is a system of adjustable exchange rates in which the exchange rates of the Member States fluctuated within set limits. It was expected that this system would stabilise exchange rates, control inflation and be a spur to trade. Also developed was the ERM II system, as aid to countries that do not have the euro so that, respecting common economic criteria, they can prepare for membership in the Union.

MAASTRICHT CRITERIA – principles laid down in the Maastricht Treaty of 1992, when the Member States set up the EU and agreed on these criteria for the establishment of economic and monetary union and a single currency: (1) the rate of inflation can be at most 1.5% greater than the average rate of inflation of the three EU countries with the lowest inflation; (2) long-term interest rates must not be 2% higher than the average of the three EU countries with the lowest inflation; (3) the deficit of the national budget must not be greater than 3% of GDP; (4) the public debt must not be more than 60% of GDP; (5) the national currency must be in the normal ERM range (Exchange Rate Mechanism) during the two previous years.

PHARE PROGRAMME – an assistance programme set up in 1989 after the fall of communism in the countries of Central and Eastern Europe, the objective of it being the reconstruction of these countries. At first it covered only Poland and Hungary and was called Pologne-Hongrie: Assistance à la restructuration économique (hence the acronym). In time it spread to the countries of CEE (apart form Poland and Hungary, these are Albania, Bulgaria, Czech Republic, Estonia, Macedonia, Latvia, Lithuania, Romania, Slovakia and Slovenia, with the PHARE programme being replaced in 2000 in Albania and Macedonia by the CARDS programme). Apart from giving help to the reconstruction of the economies of these countries, PHARE is the main financial instrument of the pre-accession strategy of the ten countries of Central and Eastern Europe that have submitted applications for EU membership. The objectives of the PHARE for the 2000-2006 period are mainly related to the construction of the institutions and the financing of investments in applicant countries.

PRE-ACCESSION STRATEGY – a form of assistance that ought to facilitate the economic and political transition in the countries of CEE. The European Council adopted it in 1994, and it is based on a deepening of the associated countries and EU institutions, development of the association agreements, financial aid via PHARE and preparations for integration into the single market.

SOCIAL POLICY PROTOCOL – this was adopted in Maastricht in 1991, and was signed by 11 countries of the EU (the UK did not sign). It was subsequently signed by Austria, Finland and Sweden. In it, the states signatories expressed their intentions to increase employment, improve conditions of work and life and so on. This topic was later included in the Amsterdam, and the Social Protocol ceased to exist as a separate document.

STABILISATION AND ASSOCIATION AGREEMENT, SAA – a new generation of Europe agreements offered to the countries of SEE as part of the stabilisation and association process. The Agreement governs the general principles, political dialogue, regional collaboration, the free movement of goods, the movement of labour, the foundation of legal entities, the provision of service and capital, harmonisation of laws, implementation of laws and rules of market competition, justice and internal relations, political and financial collaboration. The Agreement gives a signatory country the status of potential applicant for membership in the EU. Croatia signed such an agreement with the EU on 29 October 2001.

STABILITY AND GROWTH PACT – the foundation for the third degree of the establishment of the EMU which started on 1 January 1999. Its objective is to ensure the budgetary discipline in the member countries after the introduction of the single currency. According to the provisions of the Pact, the European Council can penalise a Member State that does not undertake measures to reduce an excessive deficit.

STABILITY PACT FOR SOUTH EASTERN EUROPE – a political document agreed on 10 June 1999 in Cologne, with the strategic objective of the convergence of the countries of SEE on the Euro-Atlantic structures and the strengthening of mutual collaboration. The pact sets up a framework for the collaboration of the states of SEE, the Member States of EU, the USA, the Russian Federation, international organisations (including international financial institutions) and various region-

al initiatives. In Croatia, it is the Ministry of Foreign Affairs that is charged with the coordination of all activities related to the Pact.

TRANSITION INDICATORS – a system of qualitative indicators for the transition countries that are published by the EBRD. In accordance with them, in values of from 1 to 4+, grades are given to the restructuring and privatisation of the corporate sector, the liberalisation of the market and the condition of financial institutions.

TREATIES OF ROME – these were signed in 1957 in Rome during the foundation of the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM). They also set up a customs union among the countries of the ECSC (European Coal and Steel Community) and the objectives for the creation of a common market to ensure the free movement of people, goods, services and capital were laid down. The EEC and EURATOM treaties are often known as the Treaties of Rome.

TREATY ON THE EUROPEAN UNION, EU TREATY – a treaty that set up the European Union and defined the objectives of the EMU, the single currency, common foreign and security policy, a common defence policy, the introduction of Union citizenship and close cooperation in justice and internal affairs. The Member States signed it in 1992, and ratified it in 1993.

URUGUAY ROUND – trade talks that started in 1986 in Uruguay. It was only in 1994 that an agreement was signed by the ministers of 125 countries meeting in Morocco. Although the negotiations lasted many years, they are considered to have been successful because they covered a number of trade matters and heralded the foundation of the WTO.

WHITE PAPER – an EU document with proposals for future activities in a given area.

List of useful web addresses

Name of institution	URL	Descrption
CEFTA	http://www.cefta.org/	Site devoted to the Central European Free Trade Agreement
European Commission in the RC	http://www.delhrv.cec.eu.int/	Delegation of the European Commission in the RC
EFTA	http://www.efta.int/structure/main/index.html	Site of the European Free Trade Association
Economical and Social Committee of the EU	http://www.esc.eu.int/	Useful links to the European Parliament, the EU and the European Commission
EU Business	http://www.eubusiness.com/	News from Europe and the EU
EU in the USA	http://www.eurunion.org/	Publications, information about the EU in the USA; list of web sites of EU Member States
EUObserver	http://www.euobserver.com/	EU site with latest news from Europe
European Investement Bank	http://eib.eu.int/	
European Central Bank	http://www.ecb.int/	
European Union	http://europa.eu.int	Official site of the EU
	http://europa.eu.int/comm/enlargement/enlargement.htm	EU enlargement site
Statistical Office of the EU	http://europa.eu.int/comm/eurostat/	
Council of the EU	http://ue.eu.int/	
European Commission	http://europa.eu.int/comm/index_en.htm	Official portal of the European Commission
	http://europa.eu.int/comm/enlargement/docs/newsletter/weekly_arch.htm	*Newsletter* of the European Commission general administration for enlargement

European Parliament	http://www.europarl.eu.int/	Tasks; members; announcements from Parliament
European Movement	http://www.europeanmovement.org/	
Ministry for European Integration	http://www.mei.hr	The RC and European integration programmes in the EU
	http://www.mei.hr/default.asp?ru=16	European integration glossary
	http://www.mei.hr/download//2002/06/05/ E-H Glosar-final.pdf	English-Croatian glossary of the SAA between the RC and the EU and the Member States
	http://www.mei.hr/download/2001/08/02/ PIAeng.pdf	Government of the RC Action plan for European Integration
NYU School of Law – Jean Monnet Center	http://www.jeanmonnetprogram.org/ calendar/index.html	Annual calendar of conferences and seminars related to European integration
Stability Pact	http://www.stabilitypact.org/	
PUMA	http://www.oecd.org/puma/	OECD site; topic is the reinforcement of the exchange of information related to the area of admisitration and the organisation of public sector
SIGMA	http://www1.oecd.org/puma/sigmaweb/ index.htm	OECD and EU site concerning state administration and public sector reform in the countries of CEE
Slovenija doma i u Evropi	http://evropa.gov.si/	EU site of the Information office of the Republic of Slovenia concerning Slovene accession to the EU
Sud Europske zajednice	http://curia.eu.int/	
Sud revizora EU	http://www.eca.eu.int/	

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