

# Croatian Accession to the European Union : Facing the Challenges of Negotiations

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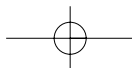
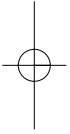
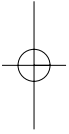
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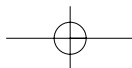
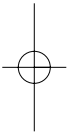
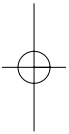
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**CROATIAN ACCESSION TO  
THE EUROPEAN UNION**  
**Facing the Challenges of Negotiations**

**Third volume**





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**Third volume**

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**Katarina Ott**

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## **CONTENTS**

<b>Authors</b>	<b>vii</b>
<b>Foreword</b>	<b>xiii</b>
<b>Acknowledgements</b>	<b>xiv</b>
<b>Abbreviations</b>	<b>xv</b>
<b>1. Croatia and the European Union: accession as transformation</b>	<b>1</b>
Katarina Ott	
<b>2. What does an enlarged European Union mean for Croatia?</b>	<b>31</b>
Ana-Maria Boromisa	
<b>3. Trade integration and Croatian accession to the European Union</b>	<b>61</b>
Vedran Šošić and Boris Vujčić	
<b>4. Freedom of movement of workers in the enlarged European Union and its effect on Croatia</b>	<b>85</b>
Mirta Kapural	
<b>5. How prepared is Croatia for a knowledge-based society?</b>	<b>109</b>
Predrag Bejaković	
<b>6. Evaluation of Croatian innovation capability</b>	<b>129</b>
Zoran Aralica and Katarina Bačić	

vi

<b>7. Extended social Europe? Social policy, social inclusion and social dialogue in Croatia and the European Union</b>	<b>161</b>
Paul Stubbs and Siniša Zrinščak	
<b>8. Free movement of capital, the real estate market and tourism: a blessing or a curse for Croatia on its way to the European Union?</b>	<b>185</b>
Dubravko Mihaljek	
<b>9. Accession to the European Union and physical (spatial) planning in Croatia</b>	<b>229</b>
Jasenka Kranjčević	
<b>10. How prepared is Croatia to access European Union regional policy funds? The case of Istria</b>	<b>249</b>
Ines Kersan-Škabić	
<b>Glossary</b>	<b>279</b>
<b>List of useful web addresses</b>	<b>292</b>
<b>Index</b>	<b>294</b>

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viii

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x

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## FOREWORD

During recent years, since the start of the project “EU Monitoring” in 2002 and its first publication, Croatia has successfully accomplished important steps on its way to EU membership. The steps on this way were, first, overcoming the international isolation that had characterised the country during the nineties, then the signing of the Stabilization and Association Agreement with the EU in October 2001, followed by the official application for EU membership in February 2003, which obtained a positive response from the EU in April 2004, and finally the accordance of status of candidate country in June of the same year. In December 2004 the European Council of the enlarged EU then announced the date of the 17<sup>th</sup> of March 2005 as the starting point for the negotiation process. At the political level, integration with the EU has been the main priority of the two governments in power since 2000 and has had the support of all major political parties. While during this period the majority of the population welcomed this policy, during the last year there was a surprisingly strong decline in enthusiasm in Croatia for the EU. Even without consideration of the details of this development, this change indicates that accession to the EU and the related reform process may have also led to fears and negative expectations.

Although Croatia can look back to an accession process that has been largely successful, a lot of problems at different levels of society still remain and have to be tackled in order to meet the requirements of EU membership and to adapt to EU standards. In this context, and with regard to the positive response to the results of the EU Monitoring project from the Croatian public as well as from international circles, the Friedrich Ebert Stiftung and the Institute of Public Finance in Zagreb are continuing with the project of analysing and evaluating the EU accession process of Croatia by Croatian researchers. Apart from the regular official reports on the progress of the implementation of reforms in Croatia by the government and international organisations, we deem it important to present a critical view by independent domestic experts on the accession process, covering political, economic and social fields. In these annual reports, which we intend to publish during the years to come as well, we want to contribute to the public debate on the development of Croatian society in the process of EU integration. The recently ambivalent attitude to EU membership of the Croatian population shows that public discussion on this topic is desirable and necessary.

With the aim of elaborating a comprehensive view of the accession process and covering various aspects of it, we have chosen a different focus for each of the publications. While the content of the first book concentrated on the economy, legislation, and civil society issues, the second one dealt rather with institutional aspects of policy issues and legislation<sup>i</sup>. This time we have put the focus on EU accession and its requirements as a key to the transformation of society. It is known from the experiences of other countries that EU accession is indeed a strong stimulus and a driving force for the implementation of reform programmes. One should not forget that, regardless of the requirements and conditions in the context of the EU membership, Croatia still needs reforms to transform the society for its own good. Like the two other publications, this report also attempts to give the reader an in-depth view of some of the political and economic problems in the context of EU accession. As well as distributing the present book to the interested public and relevant institutions the Institute of Public Finance and the Friedrich Ebert Stiftung intend once again to organise a series of workshops in the course of the year on the topics of the different chapters presented in this study for an intensive discussion of the problem areas among experts. Through this publication and the subsequent workshops we wish to provide a useful contribution to the public debate about Croatia's accession to the EU, which is vital for the acceptance and implementation of the necessary reforms on this way.

Finally, I would like to thank all those who contributed to this project, in particular Dr. Katarina Ott, director of the Institute of Public Finance and editor of the book, for her contributions and the fruitful cooperation with her Institute, and Prof. Dr. Nenad Zakošek from the Faculty of Political Sciences for his cooperation and assistance in editing the contributions.

Zagreb, January 2005

Dr. Rüdiger Pintar  
Friedrich Ebert Stiftung  
Head of the Regional Office for  
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<sup>i</sup> "Croatian accession to the European Union: economic and legal challenges", Zagreb, 2003 and "Croatian accession to the European Union: institutional challenges", Zagreb, 2004.

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Although I am afraid that these acknowledgements will resemble those in the previous two books, this is probably inevitable.

First, I would like to thank friends and colleagues from the Friedrich Ebert Stiftung for their financial support and interest in the complicated and knotty issues of Croatia's preparations for accession to the European Union, if and when it comes. I am particularly grateful to Rüdiger Pintar, who is unfortunately leaving us after the completion of this book, and Nenad Zakošek, who will luckily stay with us and our joint project.

I would also like to thank a constantly growing group of colleagues some of whom have cooperated on one, some on two and some on all three of the books. I am grateful to them all for the team spirit that is present not only in the books but also at our numerous thematic workshops and formal and informal gatherings. I also have to thank them all for enduring enormous numbers of email exchanges, discussing sometimes absurdly minor issues from economic, legal or political problems, sometimes matters of language and phrasing.

Thanks go to translator and copy-editor Graham McMaster, copy-editor Zlata Babić, Marina Kesner-Škreb author of the glossary, Martina Fabris editor of bibliographies and Pava Turudija technical editor of the book. This year I can also thank Rebecca Prebble, a young intern at the Institute of Public Finance from Victoria University, Wellington, New Zealand, who carefully read English versions of the papers.

Anonymous peer-reviewers should also be thanked, as each paper had at least two of them. Peer-reviewers did a patient, responsible and not too rewarding job of making sense of all the ideas and approaches. Thanks to them the papers are now in much better shape.

Particular thanks go to Marina Nekić, my right-hand, who perfectly coordinates everything – from meetings and workshops to printing and media, and everybody – authors, translators, copy-editors, and me, of course.

Zagreb, December 1, 2004

Katarina Ott  
Editor

## ABBREVIATIONS

AER	Assembly of European Regions
BERD	business expenditures on research and development
CADSES	Central European, Adriatic, Danubian, South-Eastern European Space
CAP	Common Agricultural Policy
CARDS	Community Assistance for Reconstruction, Development and Stability
CBS	Central Bureau of Statistics
CEC	Commission of the European Communities
CEE	Central and Eastern Europe
CEEC	Central and Eastern European countries
CEFTA	Central European Free Trade Agreement
CEU	Council of European Union
CF	Cohesion Fund
CI	Community Initiatives
CIS	Commonwealth of Independent States
CIS	Community Innovation Survey
CN	combined nomenclature
COMECON	Council for Mutual Economic Assistance
CONSPACE	Common Strategy Network for Spatial Development and Implementation
DG	Directorate General
EA	Europe Agreement
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Commission



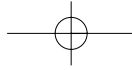
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ECJ	Court of Justice of the European Communities
EEA	European Economic Area
EFTA	European Free Trade Association
EIS	European Innovation Scoreboard
EPO	European Patent Office
ERDF	European Regional Development Fund
ESDP	European Spatial Development Perspective
ESF	European Social Fund
ESPON	European Physical Planning Observation Network
EU	European Union
FDI	foreign direct investment
FIE	foreign investment enterprise
FIFG	Financial Instrument for Fisheries Guidance
GDP	gross domestic product
GERD	government expenditures on research and development
HITRA	Program hrvatskoga inovacijskog tehnološkog razvitka ( <i>Croatian Innovation Technology Development Program</i> )
ICT	information and communication technologies
ICTY	International Criminal Tribunal for the former Yugoslavia
ILO	International Labour Organisation
IMF	International Monetary Fund
ISPA	Instrument for Structural Policies for Pre-Accession

JIM	Joint Inclusion Memoranda
MNC	multinational companies
MS	member state
MZOUP	Ministarstvo zaštite okoliša, prostornog uređenja i graditeljstva <i>(The Ministry of Environmental Protection, Physical Planning and Construction)</i>
NAPs/Incl	National Action Plans on Social Inclusion
NCC	National Competitiveness Council
NDP	National Development Plan
NECA	National Classification of Economic Activities
NGO	non-governmental organization
NIC	National Innovation Capacity
NIS	National Innovation System
NMS	new member states
OECD	Organization for Economic Cooperation and Development
OMC	Open Method of Co-ordination
OPIS	Operational Programme for the Information Society
PPS	Purchasing Power Standards
R&D	research and development
S&E	science and engineering
SAA	Stabilization and Association Agreement
SAP	Stabilisation and Association Process
SAPARD	Special Accession Programme for Agriculture and Rural Development
SEE	South Eastern Europe

xviii

SF	Structural fund
SIPO	State Intellectual Property Office
SMEs	small and medium enterprises
SSSH	Savez samostalnih sindikata Hrvatske <i>(Croatian Trade Union Federation)</i>
TEU	The Treaty on the European Union
TOR	terms of reference
TSA	tourism satellite accounts
UK	United Kingdom
USPTO	US Patent Office
WTO	World Trade Organization



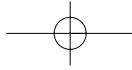
## Chapter 1

# **CROATIA AND THE EUROPEAN UNION: ACCESSION AS TRANSFORMATION**

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## **ABSTRACT**

This chapter summarizes the findings of the three year long project of monitoring Croatia's preparations for EU accession, if and when it comes, performed by a group of Croatian researchers. The first hypothesis is that a kind of real integration of Croatia in the European space already exists and that it should be further deepened through improvements of the relevant institutions and harmonisation with European standards and requirements. The second is that despite the professed dedication of Croatia's government to joining the EU and encouraging signals from the EU, hesitations in structural and institutional reforms may hamper not only the success of future negotiations and delay Croatia's accession, but also the transformation to a modern and efficient state. The first part of the chapter analyses the changes in the last couple of years in Croatia regarding the administrative and judicial structure, economic sustainability and democracy, human rights and fundamental freedoms; the second part emphasizes the effects of the latest EU enlargement, competitive pressures and market forces, the free movement of workers, knowledge and innovations, social issues, the real estate market and spatial planning, and regional policy. The chapter ends with conclusions and recommendations. We would lay stress on the necessity of structural reforms in legislation, the judiciary and the public administration, the restructuring of agriculture and ship-building, the privatization of public utilities and tourism; patient and



2

shrewd negotiations with the EU, and the possibility of bearing in mind some kind of virtual membership that could help us deepen de facto integration even without de jure membership status. Croatia's future will depend on capabilities of the government to implement and enforce the reforms and on the readiness of citizens to endure necessary adjustments even when they are painful, making certain sacrifices in the present for the sake of benefit in the future.

**Key words:**

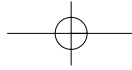
European Union, Croatia, accession, transformation

**INTRODUCTION**

The first hypothesis of this chapter is that a kind of de facto integration of Croatia in the European space already exists and that it should be further deepened and developed through the building of the relevant institutions and via harmonisation with European standards and requirements.<sup>1</sup> The second is that despite the ostensible dedication of Croatia's government to join the EU as soon as possible and despite encouraging signals from the EU, hesitations in structural and institutional reforms may hamper the success of future negotiations and delay not only the actual date of Croatia's EU accession, but also the conclusion of the transformation of the country into a modern and efficient state. This leads us to two conclusions. First, the citizens of Croatia should use the accession process as an incentive for constant improvements of the economic and institutional preconditions for stable economic growth, development and democratization, regardless of formal integration. Second, the government has to do its best to speed up these processes, moving from rhetorical declarations to concrete policy actions and measures.

Trying to raise the awareness of citizens and awaken the government from its over-satisfied state of mind, we have to ask ourselves at which stage of the de facto integration Croatia really is, what the problems are, what the possible solutions for those problems are, if our efforts to solve the problems are fast enough and if they are on the right track, as well as what can be expected in the immediate and long-term future.

For that purpose, we are dealing with the issues we deem to be the most relevant at this moment, having in mind not to repeat the issues we already dealt with in our previous two books.



The first book (Ott, 2003) emphasized economic and legal challenges. Having dealt with issues like macroeconomics, banking and finance, taxation, state aid, trade policy, energy, agriculture, employment, the legal system, civil society and gender equality, we realized that it is not enough to familiarise ourselves with the EU framework and requirements, to compare Croatia with other countries and enumerate Croatia's advantages and weaknesses. We concluded then that the most important factor in the process of the accession – and we were not even speaking at that time about accession, rather using the less-presumptuous word association – would be the role of Croatian citizens in achieving economic development, efficient institutions and a society that respects laws and individual rights.

In all the fields we were dealing with we emphasized problems of education (not just the basic educational needs of population, but also specific education about the EU, e.g. the *acquis* and Common Agricultural Policy), quality of public administration and independent agencies, normative vs. real conformity with EU rules, regulations and requirements, decisions about adjustments being made at once or later and of course sensitive issues of attitude towards regional initiatives. The particular problems we discovered were related to civil-society-building and the protection of individual rights.

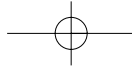
That led us to the second book (Ott, 2004) emphasizing institutional challenges. Institutions are not only fashionable, but also important for both the economy and society as they can influence the level of GDP growth and stronger democratization. In this context we analysed the macroeconomic and fiscal system, poverty, inequality and social exclusion, the rule of law and the judicial system, governance and public administration, consumer, environment and minority group protection, education and science, and finally social values. Going deeper into the enumerated fields we realized that, unfortunately, adjustments are often just normative, the bureaucracy is flourishing, the laws are often poorly harmonised and equally as often deficient, causing problems in the courts, and that we have to be aware of the problems that will arise with the accession of neighbouring countries. We realized that the key issues with or without the EU accession will be: a firm will and dedication to reforms within the country, better application of existing and faster establishment of new rules and institutions, quality and depoliticisation of public administration and particularly the judiciary, and of course the quality and preparedness of institutions for the deregulation and liberalization of markets.

Aware of the uncertainty of the possible date of any future Croatian accession to the EU, which could depend on our own preparedness or the lack of it, the preparedness or the lack of it of Bulgaria and/or Romania, attitudes within the EU towards Turkey, and the probable fatigue of the EU with the last enlargement and changes and problems derived from it, in this third book we are, as emphasized at the beginning, concentrating on the accession process as the key to the transformation of Croatia. We want to emphasize the international context, the eventual consequences of the latest EU enlargement, our “competitive stance” with Bulgaria and Romania, and the aspects of the *acquis* we did not deal with in previous books, or which if we did deal with, we now find particularly important in some different viewpoint, in this book we are concentrating on the meaning of the enlarged EU for Croatia, Croatia’s trade integration, freedom of movement of workers, preparedness for the knowledge-based society, Croatia’s innovation capability, social policy, social inclusion and social dialogue, free movement of capital, the real estate market and tourism, urban (spatial) planning, and finally regional policy.

The following part of the chapter will first analyse the changes in the last couple of years regarding the administrative and judicial structure, economic sustainability and democracy, human rights and fundamental freedoms. The second part will give a brief overview of the main topics of this book. The text ends with overall conclusions and recommendations.

## **CHANGES IN CROATIA IN THE LAST COUPLE OF YEARS**

Regarding the EU framework for accession negotiations with Croatia, our progress will greatly depend on the fulfilment of the Copenhagen criteria; sustainability of political reforms, regional and ICTY cooperation; respect of the liberty, democracy, human rights, fundamental freedoms and the rule of law; administrative and judicial structures; commitments to the Stabilisation and Association Agreement (SAA) and *acquis* requirements (Enlargement Weekly, 2004). These are all the issues fitting nicely within the context of all our three books. If we in that context look at the changes regarding the issues we were dealing with in last couple of years, government seems to be well aware of



problems and priorities, promising a lot, but not delivering enough. Reform of the judiciary for example seems a high government priority, and the budget of the relevant ministry is constantly growing, but the number of unsolved cases that is one of the biggest problems of our judiciary is still rising. So, let us try to group some of the main issues.<sup>ii</sup>

### **Administrative and judicial structure**

The Government is ostensibly dedicated to the reform of the *public administration* emphasizing anti-corruption, land registers, the cadastre and a code of behaviour for public employees. The public administration has been undergoing constant reforms, but changes are often made without previous analyses of needs or subsequent evaluations of effects and it is difficult to foresee the results. The best example is the overnight reorganization of government, i.e. the decrease of the number of ministries and establishment of government offices in 2004. There is no long-term strategy and often no necessary coordination. For example, Ministry of European Integration is in charge of public administration changes for EU purposes and the Government Office for Public Administration for domestic purposes. In addition, this Office is often overburdened with pressing short-term issues (like preparations for the elections) and is thus unable to pursue the more important long term strategy of public administration.

Similar conclusions could be drawn regarding *governance*: superficial reforms without real contents and new laws and amendments of existing ones without attention to their implementation. The rule of law – there have been certain new laws passed, but there are still a huge number of unsolved cases and poor criteria for electing judges; de-politicization – and yet the number of politically appointed people in the public administration (deputy and vice ministers, government secretaries) increasing; openness to citizens – a new law, but still there are complaints of journalists, placing Croatia 84<sup>th</sup> behind all the other Central and Eastern European countries (CEEC) except Romania in the global free press ranking (Freedom House, 2004); anti-corruption – new laws but the immediate amendments and poor results make Croatia share 67<sup>th</sup> place with Poland, while all the other CEEC are far in front and only Romania lags behind (Transparency International, 2004).

The problems with the reform of the public administration and quality of governance can be nicely shown in the case of the *energy*



*sector*. As a result of stagnation in public administration reform in Croatia, but also of the new requirements within the *acquis*, the level of harmonization with EU requirements in that sector is unfortunately decreasing. Regarding the capability of the Croatian energy sector to confront the competition in the EU, we lack harmonization with the new *acquis*, the relevant rules and regulations have not been passed, and efficient control and adequate penalties have not been established. A strong lobby within the sector is an additional obstacle to successful reform. Another issue – successful regional cooperation – will also require substantial legal adaptations, but again they will not be sufficient without efficient enforcement. Real adjustments of the Croatian energy sector should not be a problem, but restructuring is facing great resistance and it could hamper competitiveness not only at the regional and EU levels, but within the country too. Here we could mention that unfortunately overall competitiveness in the country has deteriorated, placing us 61<sup>st</sup> in 2004 in comparison to 53<sup>rd</sup> in 2003 in the world behind all CEEC except Romania (World Economic Forum, 2004).

The *legal system* is still struggling with the conflict of normative vs. real conformity, but the relationship with the EU is improving constantly. If we compare its reports from 2002 and 2004 it seems that the European Commission has no more objections to the election laws (status of diasporas and minorities); human rights and minority group status, and regional cooperation. The problems still exist in the judiciary reform – particularly the inefficiency and long duration of procedures, inadequate selection and education of judges and protection of citizens' constitutional rights; regulation of Croatian public radio and television – non-transparent selection of members of the governing council that does not enable political independence and plurality and poor participation of non-government representatives; slow return of property to refugees – caused by lack of housing, inefficient local governments and a slow judiciary, and finally, cooperation with the ICTY regarding one single person, which is keeping the whole country in a stalemate position (European Commission, 2002; 2004). Unfortunately, persisting problems of redefinition of the SAA in the Croatian constitutional and legal system and the change of the legal culture regarding first of all credible interpretation of laws by the Parliament have not been dealt with yet, emphasizing the necessity to take a new course on the way to the values of a pluralistic democracy. The relevant ministry announced a complete reform package in 2004 but improvements are for the time being visible only in faster procedures in land registers, but not yet in

other fields. The Ministry is optimistic, but it seems that real projections and objective indicators are still missing.

## **Economic sustainability**

At the beginning of our project we were probably most concerned with *macroeconomic* issues relevant for EU accession, but it seems now that from year to year sheer macroeconomic indicators are the least worrying.

- Economic growth is slowing (5.2% GDP in 2002, 4.3% in 2003 and 3.6% in 2004/IIIQ), but it is still at decent levels in comparison with the majority of new and particularly the old members of EU.
- Inflation rate is stable under 2% per year.
- The external current account deficit, although still very high, is improving from 8.5% in 2002 to 7.3% in 2003, and is expected to amount to around 6% in 2004.
- Foreign debt is increasing from 67.5% GDP in 2002 to 81.9% GDP in 2003, but there are some encouraging signs that the growth has been stabilized during 2004.
- General government budget deficit is, as usual, higher than expected but is steadily decreasing and expected to be 4.5% in 2004 and 3.7% in 2005.
- Favourable economic growth has led to a slight increase in employment and a slight but steady decrease of the unemployment rate (from 14.9% in 2002 to 14.3% in 2003 and 13.8% in I-VI/2004).

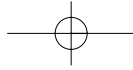
Among good signs we could also mention that Standard & Poor's raised Croatia's sovereign credit rating for long-term bonds in foreign currency (from BBB - to BBB), while the ratings for short-term debt (A-3) and debt in domestic currency (BBB+/A-2) have stayed the same. The new Country Assistance Strategy of the World Bank doubled the amount of loans for which Croatia would become eligible to 1.5 billion dollars. The main purpose of these loans will be to facilitate Croatia's integration with the EU over 2005-08. Of course, it is now up to us to use the possible funding from these sources for solid structural reforms or to squander them without positive results.

In line with the EU trends the *tax* burden in Croatia is decreasing and coming closer to EU averages. Tax revenue as a proportion of

GDP in 2002 in Croatia was 41.4% (it dropped to 41.0% in 2003), in the EU-15 (40.5%) and in the EU-25 (38.5%), but in new member states (NMS) 34.5%. The tax structure in Croatia is similar to that in NMS with lower income and higher consumption taxation, which could enhance economy. The overall tax burden still has to be lower, but that will of course depend on success in cutting expenditures and cannot happen without serious structural changes. Luckily it seems that in one of the segment of expenditure – *state aid* – there are visible improvements. The government agency became better equipped and is now expected to be capable of granting and monitoring state aid, programs for harmonization with SAA criteria and the EU system have been produced, registers and procedures improved.

The Government intends to stabilize foreign debt under 80% of GDP and lower the general government budget deficit to 3.7% of GDP in 2005. Unfortunately, it seems to be focusing more on how to raise additional revenue than on reducing the expenditure side of the budget. Privatization in key industries such as tourism, insurance and mobile telecoms has in particular been slow. Serious public administration reform has also yet to start. The slow pace of fiscal consolidation and institutional reforms could adversely affect the development of the private sector and put at risk potential growth of the economy as a whole. Croatia will also need to implement deep structural reforms in the fields of legislation, judiciary, agriculture and shipbuilding, and privatize public utilities and many enterprises in the tourism sector. Judging by the experience of many countries, these reforms and privatizations would have positive effects on both the pace and the extent of fiscal consolidation.

Because Croatia became an official EU candidate, meaning that it could start using the pre-accession funds, because the Ministry of Finance changed its fiscal projections for 2005-07, and because following the experiences of NMS Croatia's GDP has to be adjusted for the unregistered part of the economy, we could expect lower *costs of the possible 2007 accession for the budget* than previously calculated – amounting to 0.65% of the 2007 GDP. Unfortunately, the budgetary deficit is expected to be higher, amounting to 3.55% of the 2007 GDP (more about the calculations Cuculić, Faulend and Šošić, 2004). Although the fiscal discipline has been deteriorating in many EU member states and we could probably expect some changes in the Stability and Growth Pact by the time Croatia becomes a member, it does not mean that we could loosen the fiscal discipline. Croatia's budgetary



deficit is still at much higher levels than the proscribed limit. What can we conclude? External factors like the status of candidate have improved the fiscal projections while internal factors like fiscal discipline have worsened them. Again, the EU behaves encouragingly.

### **Democracy, human rights and fundamental freedoms**

Looking first at the *non-governmental sector* we could say that various good initiatives like the National Forum on Europe, the National Foundation for the Development of Civil Society, the Program of Information and Education on the EU for NGOs have been started. They are all good new initiatives and let us hope they will – particularly having in mind the dilatoriness of the government – improve the weak status of NGOs vis-à-vis the government in Croatia and provide them greater influence in society.

One of the issues that are constantly under the magnifying glass of the EU is certainly the *protection of minorities*. We are witnessing various legal improvements regarding minorities, language, education, return of refugees and reintegration, but also problems in practice. Problems are not due only to the various obstructions, but also arise from poor housing, the still turbulent economic conditions in regions of special concern that are being addressed with state aid to those regions. There are also institutional improvements like councils of national minorities (230 councils are registered) but there is little interest in participating in them. Despite many positive steps, further harmonization with European laws and European positive practices is necessary, and particularly education both of the majority and of the minority population.

Antidiscrimination laws were passed regarding *equality of men and women*, protection against violence in the family, and there has been legislation regulating same-sex communities. A government office for equality was established and public legal officer appointed. Normative adjustments seem perfect, but practice is lagging behind. Laws offer solutions on paper that are not enforced in practice because the new concepts are often not understood, some provisions are incomplete or unenforceable, citizens do not report and the police are often not sensitized enough.

When it comes to *consumer protection* there have been some improvements regarding the formation of institutions responsible for the implementation of consumer protection. However, the relevant law is

not considered to be precise enough, and is deemed lacking in coverage and to contain loopholes. Consumers' complaints are numerous, amendments and changes of the law are already in preparations, and the national program is lagging behind. Reasons lie in the reorganization of the relevant ministry as well as in poor information of citizens (only 20% of them are aware of their rights arising from the law) and of the traders. There are also funding problems – funds from CARDS are not used yet and there are fears that they might not be used at all – and problems in communication and co-ordination among the relevant actors.

There are also no spectacular improvements in *environmental protection*, but certain improvements are visible in regulations on the access to information and preparations for CARDS project regarding improvements in environmental legislation. Encouraging enough seems that public is – despite the controversies within the government – extremely engaged in some environmental issues like for example Družba Adria pipeline.

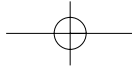
We can here conclude that government is aware of the necessary moves and although delivering too slowly – mostly in form of new or improved laws, regulations and institutions – at least prerequisites for further changes are being established. Changes in administrative and judicial structure are certainly the most worrying, economic situation seems promising and changes in the level of democracy, human rights and fundamental freedoms probably the most encouraging.

## **FACING THE CHALLENGES OF NEGOTIATIONS: HOW WELL IS CROATIA PREPARED?**

### **Effects of the latest enlargement**

Looking at the possible effects of the latest enlargement, *Ana-Maria Boromisa* concludes that integration into the EU is, due to its size, level of development, geographical position and already established economic links economically the best option for Croatia. The decision should be made: is there anything more strategic than the EU (like fisheries and oil in Norway) and how much are we ready to pay for EU membership without knowing its timeframe?

Reforms are transition-related and their result should enable sustainable growth. These reforms would still have been needed even if the



EU had not enlarged, and if Croatia had not signed the SAA. Enlargement and establishment of free trade zone hence highlight the need for reforms, might speed them up and can be regarded as beneficial for Croatia in spite of the fact that they create adjustment costs. In that context Boromisa recommends examining how fast is the integration possible, identifying alternative options for integration in the meantime, defining additional strategies of interests, and sequencing the reforms considering the possible timeframe for membership. It is particularly important to raise public awareness that some of the EU-related reforms are also transition-related and necessary anyway and that by entering the EU reforms and related costs do not stop.

Looking at various possible scenarios Boromisa states that the progression scenario is possible if Croatia does its part, but that this denotes the fastest possible, although not necessarily fast membership. She also warns that reforms, including unpopular ones, are often labeled “European” raising the perception that Croatia is doing its best, but that EU is not accepting us. In spite of the formal consensus around greater Europeanization such a perception might slow down reform implementation meaning that domestic policy will be crucial in the integration process.

Labelling unpopular reforms “European”, which is not always the truth, and simultaneously announcing EU membership as “strategic goal” sends confusing signals. It seems that no one is ready to say that Croatia needs reforms anyway, including unpopular ones. Still, it should be estimated how much membership might cost, and what sequencing of reforms is needed. Croatia should know its negotiating position – if membership is our strategic goal, is there really anything to negotiate?

Also, there should be a clear definition of what prices we are ready to pay for full membership (which could be distant). Although full membership is according to the analysis available so far economically the best option, Croatia should be open to “virtual membership” possibilities, such as political or economic integration and decision-shaping without full membership. There are various options and combinations of them for participating in the EU. The benefits of virtual membership include various ways of sequencing reforms. However, this implies that sufficient analyses exist for the best option to be chosen. For a small country, virtual membership could decrease costs, especially in limited human capital.

Raising public awareness that there is a life outside the EU and that reforms are needed anyway for successful transition and not be-

cause of the EU might help in keeping the pace of reforms and enable meeting membership criteria. Meeting the criteria should be regarded as Europeanisation and hence a goal and not a condition.

### **Coping with competitive pressures and market forces**

Economic criteria for EU membership require the country to be a functioning market economy capable of coping with competitive pressures and market forces within the Union. The latest opinion of the European Commission (2004) states that Croatia is a functioning market economy, but that it is unable to cope with competitive pressures and market forces within the Union. It could of course become able to satisfy the second criterion provided that it continues implementing reforms to remove remaining weaknesses.

*Vedran Šošić and Boris Vujčić* state that before the break-up of Yugoslavia Croatia was a very open economy, but while other CEEC during transition became more, Croatia became less open. Deterioration of Croatia's trade-openness ratio during the 1990s was a consequence of reduced trade with the former Yugoslav republics and the stagnation of trade with other countries. Here we have to emphasize that this approach deals only with trade in goods, without trade in services meaning that the results of trade openness would be quite different if the authors were speaking about overall trade, because of the particular importance of tourism for Croatia.

Croatia became a member of the WTO in 2000 and by the end of 2003 had signed preferential agreements with 31 countries including both old and new members of the EU. The SAA provided Croatia a favourable position, removing barriers to the exports of many sensitive products, but the SAA in comparison to the Europe Agreements, did not admit Croatia into the Pan-European Diagonal Cumulation of Origin which is a serious obstacle to the international trade.

Although the European Commission favourably assessed the Croatian ability to pursue further economic integration into the EU, Croatian trade still exhibits a strong bias towards the former Yugoslav republics, particularly Bosnia and Herzegovina and Macedonia. These biases evolved from inherited trade patterns that were supported by early conclusions of preferential trade agreements with some of those countries and by losing ground in the EU market on account of those competitors from CEEC that advanced faster in trade integration. Lost ground cannot be made good in the short run, but trade integration with

the EU should be accelerated in order to reduce existing biases and long-term costs of trade restructuring. The CEEC, probably Croatia's most serious competitors on that market, are at the same time full EU members after a decade of participation in the Pan-European Diagonal Cumulation of Origin. The existing system of bilateral trade relations actually means that a large portion of trade between Croatia and the EU is not carried out within the free trade regime, which inhibits manufacturing foreign direct investment and hinders Croatian integration into European production chains.

In order to facilitate trade integration with the EU, Šošić and Vujčić claim that it would be desirable for Croatia to join the EU as quickly as possible. Efforts to integrate more deeply with South and Eastern European countries would only provide a temporary shelter in the markets of countries that are even less open than Croatia. This strategy would increase the long-term costs of trade restructuring so it should in no case be a policy priority. This does not mean decreasing trade with the former Yugoslav republics and with some CEEC, but rather increasing trade with the EU and other countries of the world.

### **Free movement of workers, knowledge and innovations**

Despite the fears of the possible effects of opening up our borders to the wider labor markets often encountered in our media, *Mirta Kapural* states that integration already exists thanks to the provisions of the SAA, relevant Croatian legislation and bilateral agreements with several EU countries. There are already more than 2,000 registered foreign workers in Croatia, mostly in shipbuilding and construction, the majority of them from Bosnia and Herzegovina. Their number corresponds with the increased need for seasonal workers in Croatia. The majority of workers from Croatia concentrate in Slovenia, Italy, Austria and Germany. After the accession, Slovenia had to impose some limitations on workers from non-EU countries. Consequently a smaller number of workers from Croatia will be able to work in Slovenia. The experience of the NMS shows that we could expect the number of foreigners working in Croatia to increase and the number of Croatian citizens working abroad to decrease.

On our way to the EU we will be confronted with the need for further harmonization of our legislation and with a transitional arrange-



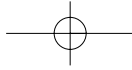
ment for the free movement of workers ranging from two to seven years.<sup>iii</sup> Croatia will have to improve legislation regarding the mutual recognition of qualifications and non-discrimination based on nationality, assure implementation of national strategies and plans, improve education and training of workers, mobilize resources by the private and public sectors and use available pre-accession EU funds. Government and media will regularly have to inform the public about the state of negotiations and try to consult professional associations and keep them informed about the rules that will apply to them.

At the moment considerable numbers of workers from Croatia are interested in seasonal work in Germany, Austria and Italy, but downward trends can be observed. Still a number of workers are interested in working in Slovenia, but possibilities could be reduced due to the transitional arrangements of the NMS. On the other hand, progress in negotiations could reduce the need of workers from Croatia to migrate. Furthermore, economic growth, lower unemployment and closer perspective of EU accession might attract more migration to Croatia, particularly from the region.

Kapural recommends preparing negotiating teams that will, using experiences of NMS and closely monitoring the negotiations of Romania and Bulgaria, try to negotiate a transitional agreement of five years, with gradual increase of freedom of worker mobility, including a standstill clause, Community preference rule and equal restrictions. The goal is to enable free movement of workers while avoiding the best young and highly skilled labour to leave Croatia and becoming overburdened with low-skilled workers from other regions.

Improvement of education and training of workers will be necessary for better placement of Croatian workers on the enlarged European labour market. *Predrag Bejaković* in his chapter fears that Croatia is poorly prepared for a knowledge-based society and that it could be a huge impediment for joining the EU market. This is a market that intends by the end of this decade to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion. That impediment could be particularly important, bearing in mind existing fears regarding Croatia's capabilities to cope with competitive pressures and market forces within the Union (European Commission, 2004).

Bejaković claims that the labour force in Croatia does not have the knowledge and skills required for a modern competitive economy, and



that the education and training systems have not yet taken the adequate steps to remedy this situation. He stresses general problems like the lack of emphasis on developing analytical and problem-solving abilities<sup>iv</sup> and weak links between education and the professional world. Particularly visible are problems of tertiary education: enrolments are relatively low, the average duration of study is long, a relatively low share of students major in the natural and technical sciences, and inadequate knowledge and skills of graduates in some social sciences. Adult and life-long education is almost completely neglected (only 0.2% of the population over 35 is participating, in comparison with EU average of 7%).

Bejaković offers numerous recommendations for improving Croatian education, but we could here stress just some of the most important: a change from a supply – to a demand-driven system, more flexibility and efficiency in the system including decentralization and privatization, and aiming for more responsibility, initiative and executive thinking in the students.

Unfortunately, numerous education strategies have been proposed, but they were neither put into operation nor fully implemented, nor were any major reforms implemented at any level.

Using the European Innovation Scoreboard *Zoran Aralica and Katarina Bačić* conclude that Croatia ranks well by European standards in comparison to other CEEC, in particular Bulgaria and Romania, but has not made a significant progress in its innovation potential and policy with respect to the EU. In *human resources indicators* Croatia is close to the EU average in science and engineering graduates, population with tertiary education and employment in high-tech services, but far below the EU average in participation in life-long learning. Croatia ranks unfavourably in all of the *indicators of knowledge creation* – lagging behind the EU average slightly in public R&D indicator, but seriously in business expenditure on R&D and catastrophically in patent applications. When it comes to the *transmission and application of new knowledge indicators*, Croatia ranks fairly well relative to both the EU average and the CEEC values – exceeding EU average in SMEs involved in innovation cooperation and SMEs innovating in-house, but lagging behind in innovation expenditure.

The Government has stipulated establishing a modern innovation system among microeconomic and structural priorities, an innovation technology development program exists, the National Competitiveness Council placed innovations among top priorities, but no national industrial strategy incorporating an innovation policy has yet been passed.

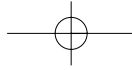
The results of international comparison of indicators and current institutional settings in the country mean that Croatia needs: a modern national innovation system, changes in the scientific and higher education policies to integrate them into the European Research Area, inclusion of the principles of life-long learning, particularly among the unemployed, plus stronger efforts in innovation policy implementation, but also in coordination with other areas of economic policy, in particular science and technology, SMEs and industrial policy. Among the recommendations Aralica and Bačić stress: setting explicit goals and targets of innovation policy, better implementation of programs, removing the obstacles to financial instruments, setting a statistical base for innovation policy measures and instruments enabling assessment, monitoring and evaluation.

Obviously, substantial improvements are needed. In theory, innovative policy is a topic, but in reality improvements can not be made overnight or by the government only. Improvements will depend on changed attitudes of the population and the business sector and changes in the business environment. The Government should bear in mind that the situation will not be improved by the greater allocations of funds but through reform of educational system and science, setting qualitative standards, principles of monitoring, evaluation and rewards for standards of quality.<sup>v</sup>

## **Within the extended social Europe**

Dealing with the Croatian position in the extended social Europe, *Paul Stubbs and Siniša Zrinščak* elaborate how social policy and social inclusion are today much higher on the agenda of the EU than before, but still social policy improvements depend on the individual countries and not much help can be expected from the EU. Luckily EU opinions regarding social policy in Croatia are sparse and generally favourable. In terms of social protection the last report calls the Croatian system generous when compared to the size of the economy (European Commission, 2004).

With limited formal influence from the EU but influenced by a mix of international actors the Government has been undertaking various social policy reform activities: the 2001 decentralization promoted social dialogue; the 2002 program for combating poverty and social exclusion addressed also the role and tasks of different government



agencies, unfortunately going no further than paper statements; the 2002 social welfare reform project regarding social services, social assistance, labour market policies, monitoring and measuring poverty leading to data on poverty which included some of the Leaken indicators being produced in 2004; relevant agreements with social partners were signed and the office for social partnership was established; Croatia ratified the European Social Charter with its three additional protocols. Despite a lot of efforts on the part of Croatia and good evaluations from the EU, various problems still exist.

EU financial support to Croatia in the social policy field has been limited and mostly oriented towards refugee return and the war-affected regions. Croatia produces minimalist reports which are rarely part of any wider process of awareness-raising and of consultation with stakeholders. The lack of strategic direction in social policy, the failure to resolve key issues such as the role of the state centers for social welfare and the role of non-state actors, both in civil society and in the private sector, and the absence of decentralized, meaningful social planning mechanisms. There appears to be little or no discussion of the importance of community-based provision over and above institutional care. No short, medium or longer term outcome indicators for future social protection. The co-ordination of different policies, including the recently developed family policy, is also not well developed.

Stubbs and Zrinščak suggest greater efforts be invested in the elaboration of the core principles of social dialogue and of social policy, in the strengthening of social dialogue and the promotion of social inclusion, and in measures for implementing social dialogue and strengthening social protection systems. Progress is needed in improvements of statistics and data, introduction of internationally comparable qualitative and quantitative indicators of social exclusion and poverty as well as methods for their calculation; in the alignment of legislation with the social *acquis* and in effective implementation of the provisions over the medium term: preparation for communication processes at the EU level on employment, social inclusion and pensions. There should be a process of consultation with all the stakeholders not only at the national but also at the local, sectoral and firm levels. Greater public awareness of social inclusion and social dialogue needs to be fostered.

Social protection and social dialogue are not priority areas in the relation of the EU with Croatia, because other issues like regional and local development, particularly of the war affected areas, refugee return, minority rights and the legal system are seen as more pressing problems.

Besides, Croatia appears to resemble countries of Central Europe more than Bulgaria and Romania in terms of the scale of social problems. Still, we will have to align legislation and effectively implement it.

With the exception of Bulgaria and Romania, social policy has not thus far been an important element of the pre-accession process for aspiring new members. However, because of the latest development of the European social model it may well be that Croatia will encounter more demands during the pre-accession phase. Membership – if and when it comes – will certainly create higher social tensions and make the socially excluded even more vulnerable if we do not prepare in advance. Stubbs and Zrinščak conclude that without thorough changes, we could risk being unprepared for the social dimensions of EU membership, both in the short and in the medium term.

### **Real estate market, tourism and spatial planning**

In accordance with the SAA, Croatia already has an obligation to liberalize most capital transactions and in particular open up the regime for real estate sales to non-residents after 2009, i.e., four years after the SAA enters into force. *Dubravko Mihaljek* argues that the current regime for property sales to non-residents, which will remain in force until 2009, is relatively liberal in some respects (e.g., non-residents who establish a company in Croatia can acquire real estate without restriction), but relatively restrictive, non-transparent and cumbersome in others – private individual non-residents have to wait up to one year to get permission to buy a vacation home in Croatia. This differential treatment is unwelcome for Croatia's investment profile and provides fertile ground for corruption. An unfortunate consequence of this and other forms of red tape is poor ranking of Croatia in various surveys of business climate. For instance, the Heritage Foundation (2005) ranks Croatia as 74<sup>th</sup> in the world in terms of economic freedom, in the same group as Senegal and Uganda. By comparison, Estonia is ranked as the 4<sup>th</sup> freest economy in the world.

The development of real estate and tourism industries in Croatia is also hampered by the lack of enforcement of environmental and spatial planning regulations, weak and often irresponsible local governments, and poor local infrastructure (including waste disposal facilities, sewage and local transportation). In addition, Croatian legislation provides almost no protection against property speculation. While this is

not obvious at the moment because the lack of capital largely prevents Croatian citizens from engaging in speculation, once the property market is opened up to non-residents, this weakness of the legislation could manifest itself very quickly, resulting in the meantime in potentially large disruptions in local property markets.

Unfortunately, because of the lack of information and expert analysis, these hot topics are often discussed by politicians and the general public without solid empirical, economic and legal arguments. The sides in the debate often depend mainly on ideology, lobbying interests or misperceptions. The paper by Mihaljek is perhaps the first serious attempt to understand how the opening up of the real estate market to non-residents might affect local property markets, tourism and the national economy.

Mihaljek recommends a measured approach to the opening of the real estate market to non-residents. He says that although Croatia stands to benefit in the long term from foreign investment in the property sector, in the short run a more gradual liberalization can be justified on a number of grounds. These include potential spillovers of price increases from the market for secondary residences onto the local housing market (of which there is already some evidence); costs of the adjustment in the housing market and construction industry to a sudden large increase in demand for secondary residences; loss of competitiveness in the tourism industry if there should be violations of building regulations and the resulting overdevelopment of coastal areas; and macroeconomic pressures arising from large and sudden capital inflows.

He suggests that a well articulated public discussion might help in formulating arguments that Croatia's accession negotiators could use in their attempts to extend the transitional period for property sales to non-residents. He also recommends transparent and efficient application of existing regulations on property sales to non-residents; determined implementation of building regulations, in particular in public coastal areas; improvements in the legislative framework and administrative procedures regarding property transactions; and the development of instruments and institutions of housing finance.

As the existing regime for property sales to non-residents is perceived as relatively liberal, the author's recommendation for a more gradual approach will probably be well accepted by the domestic audience. The author recognizes, however, that the negotiating process will leave Croatian officials very little room to obtain substantial concessions in this field.

However, one could also argue that Croatia needs faster and more complete liberalization and deregulation to speed up the adjustment process, not only in the real estate sector where the economy stands to profit from the inflow of capital (provided, of course there are simultaneous improvements in legislation on capital flows, speculative activities, etc.), but also in industries such as shipbuilding, where government protection, state aids, and political interference present formidable obstacles for economic restructuring. A priori, one would expect restructuring to be less costly if done sooner rather than later.

Maintaining restrictions, as is well known, leads to various informal and illegal activities. Interested buyers will always find ways. We see this already now, in that many non-residents find it less complicated and costly to register a company and buy real estate, than to wait for a "clean" procedure to purchase as private individuals. Mihaljek himself recognizes that increased foreign demand for vacation homes in Croatia might increase incentives for local governments and developers to bypass the recently introduced building regulations and cash in on the interest of foreign buyers as quickly as possible. He suggests that policy makers and the society at large will need to consider carefully the balance between restrictions on property ownership on the one hand, and regulations pertaining to the environment, urban planning, property speculation, and enforcement of building regulations on the other. I would certainly opt for the latter, as all kinds of negative behaviour could be displayed equally by foreign and by domestic owners, meaning that enforcement of regulations is crucial irrespective of the residence status of the owners.

*Jasenka Kranjčević* states that we could expect the area of Croatia to be exposed to powerful and long-term changes thanks to the preparations for accession and thanks to the fact that it is already bordering with new EU members. This means that Croatia should be better acquainted with and more involved in all the activities related to spatial development at the EU level.

War damage, the introduction of parliamentary democracy, strengthening of private property, the transition, new territorial organization, globalization and integration processes have led to a value-system crisis and the neglect of common and long-term interests in the space. The new local authorities were not prepared to take over the tasks of planning their own space; property title came to be understood as the absolute right over property without respect for the protection of public interests, there has been poor harmonization among various lev-

els of the government, poor horizontal and vertical coordination. As a consequence, local plans remain at the level of determining building zones, ill-adapted to contemporary requirements. We are also witnessing the spreading of building zones without the necessary infrastructure, poor care for waste disposal, poor data bases, unclear titles, outdated geodetic plans and poor participation in international projects.

In the area of physical planning there is no direct obligation with respect to individual chapters of the *acquis*. EU requirements relate primarily to the obligations of candidate countries to harmonize their policies and aims with the European objectives and to incorporate certain mechanisms to harmonize interests of the Union and other member states into the national legislation, to base the preparation, drawing up and acceptance of documents on principles of law and order, the welfare state, financial justifiability and a democratic society, to respect international recommendations, directives, contracts and conventions. In our accession efforts the first task will be to assess the state of affairs, determine our own objectives and policy and to harmonize them with the interests of the EU. We will have to enforce public participation, harmonize legislation, back physical planning with appropriate financial analysis, achieve better management and more effective supervision of legislation and finally ensure harmonized planning of the spatial, economic and social objectives of development.

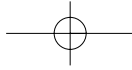
### **Using European Union regional policy funds**

In her chapter, *Ines Kersan-Škabić* explains that with a GDP level lower than 75% of the EU average and facing structural problems Croatia could expect when it becomes a member to benefit from the structural and cohesion funds of the EU.

For the time being – in accordance with the SAA and like all other countries of the Western Balkans – Croatia can participate in CARDS program intended to support reforms and build the institutions necessary to implement the SAA. Regional development is a high priority, aiming to reduce development imbalances and to strengthen local authorities.

During the 1990s the majority of funds coming from the EU to Croatia were directed towards humanitarian purposes and the amounts were relatively small in comparison to the other CEEC. EU assistance in 2002-04 focused on democratic stabilization, economic and social development, justice and home affairs, public administration, implementation of the SAA, environment and natural resources.



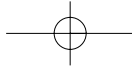


A large number of projects are available to develop the necessary institutional and economic framework in accordance with EU standards directly through PHARE, ISPA and SAPARD. Indirectly, through the cooperation of regions from Croatia with regions from the EU members, Croatia could also access funds from Interreg III. As with all other programs, funds are limited, but Croatia's absorption capabilities are probably even more so. Istria is one of the most developed regions in Croatia and one with traditional connections with several regions of the EU. It is already participating in cross-border, trans-national and interregional cooperation benefiting probably not so much financially, but more in getting acquainted with international projects and joining other EU funding possibilities. The example of Istria shows that indirect participation in EU regional funding is possible even now, but certain prerequisites should be satisfied and it depends first of all on us, not on the EU.

The problems that are constraining Croatia's possibilities for using EU regional policy funds are threefold: first, there is no single legislative act addressing problems of regional development for the entire country and the existing regional policy is oriented towards the less developed and war-affected regions; second, the Regional Development Fund is for the time being active through the budget only and is not following participation of regions in the EU projects; third, regional and national authorities are not sufficiently coordinated and harmonized in their activities with respect to foreign regions in participation in particular projects.

For improving Croatia's possibilities to access and use EU regional policy funds, it will first be necessary to establish certain development documents like a national development plan necessary for negotiating funds from the structural and cohesion funds once Croatia becomes a member, and a national strategy of regional development referring to all regions, not only those that are lagging behind. Secondly, we will have to establish and reorganize some institutions like regional development agencies at the level of the counties that will get acquainted with EU funding possibilities and methods. Thirdly, we must improve cooperation with EU regions developing inter-regional cooperation, partnerships and mutual projects at the county level and getting acquainted with developments in the neighbourhood.

EU accession could bring Croatia multiple possibilities of using EU regional policy funds. Various possibilities exist even now when Croatia is only a candidate. But, to be able to use even parts of these funds, great efforts will have to be made to avoid the situation that happened in the CEEC countries, which, thanks to low absorption capabil-



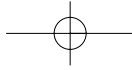
ities, used only about a half of the committed resources. Because of the great differences among Croatian regions, poor harmonization and lack of coordination, success will greatly depend on the efforts and capabilities of local governments to engage in projects on their own, irrespective of the support from the national level.

## CONCLUSIONS AND RECOMMENDATIONS

What can we conclude after closely monitoring Croatia's transformations and preparations for EU accession? Croatia has gone a long way from the first insecure days of establishing a country, fighting the war and stepping out on the path of transition from socialist to market economy. Unfortunately, that did all happen simultaneously and this constrained our prospects for joining the group of the best achievers among the CEEC. Now, to catch up, Croatia badly needs serious dedication to structural reforms in almost all aspects of its life, particularly administrative and judicial reform, restructuring of some of the most troubled industries and privatization of the public utilities. These reforms are needed with or without aspirations to EU accession.

The Government is on paper at least dedicated to reforms, but changes are often made without previous analyses of needs, evaluations of effects, and it is difficult to foresee the results. We are witnessing superficial reforms without real contents and new laws and amendments without proper care for their implementation and enforcement. There is no long-term strategy and often no necessary coordination. Government often allows itself to be overburdened with pressing short-term issues instead of addressing more important long term strategies. Rather poor rankings in various indicators like freedom of the press, perception of corruption, competitiveness and economic freedom are the consequence of such circumstances. Despite all these shortcomings, the relationship with the EU is improving constantly.

Bearing in mind all the problems with administrative and judicial capabilities, the economy is coping rather well. We could mention decent levels of economic growth and inflation rate, improvements of the current balance of payments deficit and the general government budgetary deficit (although both at rather high levels), a slight decrease in the unemployment rate, improved credit ratings and a decreasing tax burden. This all means that the Croatian economy is capable of even better achievements once the institutional setting improves. Unfortunately, foreign debt is too high and fiscal adjustments are too slow.



The Government is more concentrated on the changes in the revenue than on the expenditure side of the budget and privatization has been too slow particularly in most problem-ridden industries. Structural reforms in the fields of legislation, the judiciary and public administration, the restructuring of agriculture and shipbuilding, the privatization of public utilities and tourism are needed. These changes could lead to better fiscal consolidation and positively affect economic growth.

Evaluating democracy, human rights and fundamental freedoms we can see various legal and institutional improvements, but enforcement and practice are lagging behind. This is obvious in issues like minorities, gender, consumer or environment protection. Luckily, there are various good initiatives regarding building up the non-governmental sector, encouraging expectations for it to have a greater influence in society once the prerequisites for the functioning of NGOs have been made.

The majority of the experts agree that having in mind our current knowledge, the size of Croatia, the vicinity of the EU, accession might be the best solution for Croatia. Looking at the experiences and effects of the latest enlargement, competitive pressures and market forces, the effects of the free movement of workers, the standing of education, science and innovations, the free movement of capital, the real estate market and tourism, social policy or regional policy, it is obvious that accession to the EU in the long run could bring benefits to Croatia. But, without serious reforms, restructuring and enforcement, the accession could also have adverse effects on competitiveness, stability and the wellbeing of the society, influencing our possibilities for development and growth.

Optimism is present on the side of the EU that granted Croatia candidate status and set the date for starting negotiations, on the side of the Croatian government that finally found a relevant goal that could serve as the cohesion element in society, and finally on the side of citizens of Croatia that are despite the slight fear of changes expecting wonders from the EU accession. There are grounds for optimism in the EU having granted the country candidate status and having set a date for negotiations to start; in the Croatian Government having finally found a relevant goal to serve as a cohesive element in society; and finally in Croatian citizens, despite their qualms, expecting wonders from EU accession. But we should all be aware that disappointments might occur – if the accession does not happen soon enough or if the accession does not deliver the expected wonders. What could we suggest are the most important strategies for success?

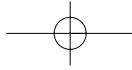
- *Structural reforms, structural reforms and structural reforms.* Croatia badly needs structural reforms in the fields of legislation, the judiciary and public administration, the restructuring of agriculture and shipbuilding, the privatization of public utilities and tourism. A successful end to these reforms will mark the successful end of the transformation. If it corresponds with the EU accession, wonderful, but Croatia will gain even if it does not. This and our previous two books give an abundance of suggestions and recommendations for the necessary reforms.
- *Patient and clever negotiations* with the EU, bearing in mind that there is not much room for negotiation. Various concessions and transitional arrangements can possibly be obtained, but permanent exceptions are almost unheard of. As several of the authors in this book state, it means that we have to know our priorities, know what we want, what the price we are willing to pay is and try to get as much as possible through the negotiations. Of course, we have to know how to negotiate. We should not waste time, energy and scarce negotiating capabilities in seeking preferential treatments in many fields, but concentrate on the most pressing ones.
- As the timeframe for our eventual accession is still unclear – despite the encouraging signals from the EU – we could also keep in mind the *possibility of some kind of virtual membership*, which could help us deepen de facto integration without de jure membership status. Virtual membership does not have to be the end of the world for Croatia, but could probably mean lower costs of adjustments and lower bureaucratization, which is desirable anyway, particularly for a country with such scarce human resources.

In the end, there is no guarantee for success. Societies use their resources in various ways – the best of them to prosper, the worst of them to collapse.<sup>vi</sup> There is a wide range of possibilities in between. Croatia's future will depend on the capabilities of the government to implement and enforce the reforms it is so vocal in speaking about and on the readiness of citizens to endure the necessary and often unpleasant reforms, sacrificing something now to be able to benefit in the future.

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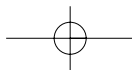
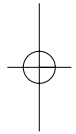
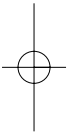
i *Interesting views upon de facto vs. de jure integration could be found in Gligorov (2004).*

ii *I would like to thank colleagues who closely monitor their fields of interest and produce the updates for the project on which relays this part of my text: Marijana Bađun, Alida Ban, Predrag Bejaković, Ana-Maria Boromisa, Judita Cuculić,*



*Michael Faulend, Ramona Franić, Marina Kesner-Škreb, Danijela Kuliš, Aida Liha, Dubravko Mihaljek, Siniša Rodin, Vedran Šošić, Alan Uzelac, Snježana Vasiljević and Igor Vidačak.*

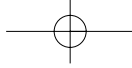
- iii *All old members except United Kingdom and Ireland introduced various transitional arrangements for free movement of workers from new member states ranging from two to seven years.*
- iv *As a sign of change we could stress that a group of professors managed to introduce the game bridge as non-obligatory course at the Electronics Faculty in Zagreb.*
- v *More about the related problems of the financing of science and higher education can be found in Bajo (2003).*
- vi *Interesting approaches to first of all environmental, but also other relevant factors why some societies succeed or fail could be found in Diamond, J. *Guns, Germs, and Steel: The Fates of Human Societies*. London: W. W. Norton & Company (1999) and Diamond, J. *How Societies Choose to Fail or Survive*. New York: Viking Books (2004).*



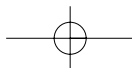
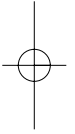
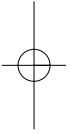
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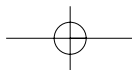
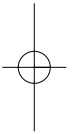
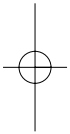
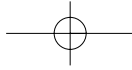
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## Chapter 2

# WHAT DOES AN ENLARGED EUROPEAN UNION MEAN FOR CROATIA?

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## ABSTRACT

Croatia missed the first wave of Eastern EU enlargement<sup>i</sup>, but it is likely to start accession negotiations in 2005. It is gradually aligning its legislation with the EU *acquis* pursuant to the Interim Agreement<sup>ii</sup>. Adjustment costs linked with the integration process coupled with the lack of a firm timetable for full EU-integration might give rise to euroscepticism, decrease readiness for reforms and slow them down. Delays in reforms related to transition and integration can endanger their effectiveness and impede development of the capacity to cope with market forces within the EU. This is the economic membership criterion. Hence, such developments can impede the fulfilment of EU membership criteria and also reduce the potential for exploiting the positive effects of integration.

### Key words:

enlargement, European Union, Croatia, candidates, membership criteria

*\*The author is taking part in this project as an independent researcher, so the views expressed are not related to the institution in which she works. Helpful comments from Katarina Ott and anonymous referees are gratefully acknowledged.*

## INTRODUCTION

The objective of the paper is to identify the major changes caused by the first wave of Eastern EU enlargement and their impact on the pace of Croatia's integration into the EU. It also examines the options for Croatian participation in the integration process in the period before full EU membership.

First we analyse EU requirements and how the enlargement is changing the level at which membership criteria are met. Next, we discuss the possible economic impacts of the enlargement on Croatia and its ability to integrate into the EU market. In addition to the economic aspects of enlargement, the paper identifies some of the institutional and negotiating issues that should be taken into consideration when revising the position of Croatia vis-à-vis the enlarged EU and the other candidate countries (Bulgaria, Romania and Turkey).

Based on the analysis of these elements, we argue that the EU enlargement will intensify the effects of Croatia's associated EU membership. Associated membership causes alignment costs which could prevail over benefits in the short run. Significant costs of the integration might give rise to euroscepticism and slow down the economic reforms necessary for exploiting the positive effects of integration in the medium to long term. Thus the establishment of association with the EU, coupled with the EU enlargement process, might lead to a slowing down of the integration process.

## EUROPEAN UNION REQUIREMENTS

The Treaty on the European Union (TEU) says that any European state that respects the principles common to the member states (liberty, democracy, respect for human rights and fundamental freedoms and the rule of law) may apply to become a member of the Union (Article 49).

An applicant state can become a full member provided that the EU membership criteria are met. These criteria are defined by the conclusions of the Copenhagen European Council (1993).<sup>iii</sup> Basically, the candidate must meet *political criteria* (stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities), *economic criteria* (the existence of a func-

tioning market economy, the ability to cope with competitive pressures and market forces within the Union) and *develop the ability to take on the obligations of membership*, including adherence to the aims of political, economic and monetary union. This means that a candidate must effectively apply the EU rules (adopt and implement the *acquis*) and policies before membership. *The EU*, from its side, *has to be ready to receive new members*. This means both that the EU's financial perspective enables implementation of the EU policies if new member states are included and that the EU's institutions are able to admit representatives of the new members into their work. Progress in negotiations is conditional upon membership criteria being met.<sup>iv</sup> The necessary reforms should be taken in the pre-accession period, which is the reason why transition arrangements are limited in scope and duration.

As the European Council has repeatedly declared, the membership criteria are going to stay the same.<sup>v</sup> But since the EU is changing, the benchmarks will change. Therefore we shall endeavor to identify the most striking changes caused by the EU enlargement.

Compliance with the *political membership criteria* has not changed upon the enlargement.<sup>vi</sup> Meeting political criteria is necessary for the progress of integration, but further economic integration is conditional upon economic reforms.

*Economic membership criteria* require, first, the existence of a market economy and second, the capacity to cope with competitive pressures and market forces within the Union. The existence of a market economy refers basically to the "domestic policies" in the candidate country.<sup>vii</sup> The capacity to cope with competitive pressures and market forces within the Union is changing as the relevant market (the EU market) changes. It requires a minimum level of competitiveness in the main economic sectors of the candidate country. The Commission evaluates compliance with the second economic criterion with respect to various elements, among which are the extent to which government policy and legislation influence competitiveness (trade policy, competition policy, state aid, support for SMEs) and the degree and pace of trade integration a country achieves with the EU before enlargement (volume and nature of goods already traded with member states).

As concerns the *requirement to take on other obligations of the membership*, enlargement is closely related to the internal development of the EU. Therefore, the candidate has to accept institutional changes, financial changes and policy reforms and align its domestic legislation with the new *acquis*. Reforms induced by the EU enlargement are nec-

essary for the functioning of the enlargement and for the development of the ability of the EU to absorb new members in the next round(s) of enlargement. For instance, new members had to align with the EU *acquis* at the cut-off date of 30 September 2003 (European Commission, 2004c:10). This cut-off date also applies to the finalization of negotiations with Bulgaria and Romania, while countries that have not started negotiations yet (Croatia) will have “more *acquis*” to align with in the pre-accession period.

From the EU side, the *capacity to absorb new members* is highly dependent on the success of the current enlargement process, a constitutional agreement and the new financial perspective. Revisions of the founding treaties agreed so far (TEU as well as draft Constitution, COREPER, 2004) have set some principles in the decision making of the EU, but have not provided answers as to how the institutions of the EU will change in the next rounds of enlargement.

## EUROPEAN UNION REQUIREMENTS AND THE ENLARGEMENT PROCESS

The inclusion of 10 new member states on 1<sup>st</sup> of May 2004 marked the biggest wave of enlargement in Union history. These countries have reached a sufficient degree of compliance with the membership criteria, but alignment is not finished yet. There are still issues requiring enhanced efforts and areas of serious concern. The latter include areas affecting the internal market and those affecting the delivery of EU funds to beneficiaries in the new member states.

Bulgaria and Romania, candidates that have been included in accession negotiations, but were unable to finish them on time, are considered to be a “part of the same inclusive and irreversible enlargement process” (European Council, 2003). Their membership has been rescheduled for 2007<sup>viii</sup>, which implies that they should sign the Accession Treaty by the end of 2005 at the latest and complete negotiations in the course of 2004. Since progress in negotiations is conditional upon meeting membership criteria, Bulgaria and Romania had to continue implementing necessary reforms. Bulgaria concluded accession negotiations in June 2004 (Bulgarian government, 2004). Romania is well advanced and will continue negotiations on the same basis and principles that applied to the ten new members.

Croatia's compliance with membership criteria before the enlargement was comparable with that of Bulgaria and Romania. Shortly before enlargement, that is, the Commission published its Opinion on the application of Croatia for membership of the EU (European Commission, 2004a). The method followed in preparing the Opinion was the same as that used in the Regular Reports. The Commission confirmed that Croatia met the political criteria set by the Copenhagen European Council (1993) and the Stabilisation and Association Process (SAP) conditionalities. The SAP conditions mostly explain the political membership criteria on an individualized basis.<sup>ix</sup> Bulgaria and Romania also comply with political criteria.

As regards economic criteria, Croatia is a functioning market economy. It should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it continues implementing its reform program to remove remaining weaknesses (European Commission, 2004a:53). Similar wording was used in the latest Regular Reports for Bulgaria and Romania.

Croatia's ability to take on the other obligations of membership has been evaluated according to following indicators:

- the obligations set out in the Stabilization and Association Agreement (SAA), particularly those already in force under the Interim Agreement, which relate to areas such as the free movement of goods, competition and intellectual and industrial property rights;
- progress in adoption, implementation and enforcement of the *acquis*.

The Commission concluded that Croatia will be in a position to take on the other obligations of membership in the medium term, provided that considerable efforts are made to align the country's legislation with the *acquis* and ensure its implementation and enforcement. In Croatia, Bulgaria and Romania administrative and judicial capacity need to be further improved to allow proper application of the *acquis*. The quality of the legislation transposed in Romania has not always been adequate, and revisions are called for making the situation comparable with that in Croatia.

Comparison of the Opinion and Regular Reports shows that the Commission shares the view of the Government that it might be possible for Croatia to meet membership criteria in the medium term, as planned by the Government. The main difference between the Regular Reports for Bulgaria and Romania and the Opinion on Croatia is that

in the Opinion the Commission stated that integration in the single market and the adoption of the *acquis* would, *at this stage*, cause difficulties for a number of sectors, related to their ability to withstand the competition within the single market. The Commission underlined that addressing the identified weaknesses should contribute to higher investment and growth, thereby enhancing Croatia's competitiveness. Such wording allows for inclusion of Croatia in the EU *at a later stage*, and sets the ground for future opinions and Regular Reports that might conclude that Croatia is not capable of meeting the second economic criterion.

However, a later inclusion in full membership should not be regarded as indicating a deficiency in the Croatian economy. Namely, in terms of the "usual" development criteria, such as GDP per capita, energy consumption, life expectancy at birth, etc. Croatia is more advanced than Bulgaria and Romania (for more see World Bank, 2004), which are considered to be part of the first round of Eastern EU enlargement. Meeting EU membership criteria basically means a successful end of the transition process (for more see EBRD, 2004) and real convergence with the EU standards have been achieved. Hence, meeting membership criteria can be regarded as a goal and not as a condition for membership.

## IMPACT OF ENLARGEMENT

In this part of the paper we briefly estimate the impact of enlargement on the fulfilment of membership criteria (which relate to both the enlarged EU and Croatia), the impact of enlargement on the Croatian economy and on the dynamics of Croatia's integration into the EU.

As identified earlier, enlargement changes the level to which a candidate country is capable of facing competitive pressures and market forces in the enlarged EU market, and the obligations of membership change with the development of the EU (new policies, a new *acquis*). From the EU's side, its capacity to absorb new members depends greatly on the development of new policies and the *acquis*.

Since the EU internal market is one of the major achievements of the economic integration within the EU, in this paper we proxy economic impact of enlargement on Croatian economy with the impact of inclusion of 10 new members in the internal market.<sup>x</sup>

## Impact of enlargement on fulfilment of membership criteria

### Economic membership criteria

As the EU expands, its internal market grows. The removal of existing trade barriers<sup>xi</sup> between old and new members and among new members increases the competitive pressures in the EU market, and by doing so can have an impact on the level to which a candidate meets the second economic membership criterion. These effects increase over time, so the time dimension of evaluating compliance with membership criteria becomes important.

The effects of enlargement require some time span to materialize. That is, “negative integration”, whose effects can be seen in the short run, has been achieved prior to enlargement<sup>xii</sup>. The period which has elapsed since the enlargement is extremely short, so the impact of enlargement cannot be evaluated on the basis its actual effects (*ex post*).<sup>xiii</sup> Consequently, we identify here the “statistical” changes brought about the enlargement, which represent the new point of reference for estimating the “real” effects of enlargement (*ex ante*).<sup>xiv</sup>

We focus on two elements used as indicators for meeting the second economic membership criterion: volume and nature of goods traded.

Firstly, after May 1<sup>st</sup>, trade with the EU means trade with 25 countries instead of 15, while CEFTA lost its most advanced members. For Croatia, the impact of the enlargement (from EU-15 to EU-25) is an increase in the proportion of its trade with the EU from under 60 to over 70% of total trade (Table 1).

Table 1 “Statistical” impact of the European Union enlargement on Croatian trade

	Exports, in % of total exports	Imports, in % of total imports	Trade, in % of total
EU-15	54.2	57.8	58.6
EU-25	67.6	72.5	72.8

Source: Boromisa (2004b)

Enlargement also caused a 10% increase of intra-EU trade and 9% decrease of extra-EU trade. Hence, one impact of enlargement is a decrease in the external trade of the EU-25, but this effect on the EU is



opposite to the effect on the individual trade partners. Hence, for Croatia, enlargement has caused an increase in the volume of goods traded with the EU.

Enlargement does not change the basic trade structure with the EU (nature of goods traded). The most important export products to the EU-15, identified at the level of 98 products according to the two-digit combined nomenclature (CN) that denotes the statistical classification of the EU were ships, clothing, electrical appliances and wood and wooden products. Exports were highly dependent on ten products that accounted for around 70% of the total Croatian exports to the EU-15. Import structure was more diversified, and the 10 most important import products accounted for around 60% of total imports. Export structure to the EU-25 has not changed significantly. The top ten export products according to the combined nomenclature remain the same, but their ranking is slightly changed. Export specialization has decreased, so instead of 71%, the top 10 products account for 67% of total Croatian exports to the enlarged EU. Import structure has changed less since the enlargement, and the top 10 products now account for 58% of total imports, as compared to the previous 61 of total imports.

Next, empirical research has shown that preparation for the single market was accompanied by a decrease in the share of inter-industry trade in Europe and a rise in intra-industry trade (European Commission, 1996). The same has happened in the candidates in the pre-accession period. The pace of trade integration with the EU has been highly positively correlated with EU changes in the export structure (IMF, 2000; see also Boromisa and Mikić, 2003). Thus more vigorous intra-industry trade implies lower specialization in different countries, lower adjustment costs and roughly similar industrial structures. The level of intra-industry trade between Croatia and EU has increased since enlargement, which implies a higher level at which membership criteria are being met.<sup>xv</sup>

Briefly, after enlargement Croatia is meeting the economic membership criteria better, especially in the part relating to the volume and nature of goods traded.

### **Requirement to take on other obligations of membership**

Croatia will have to align with “more *acquis*” in the pre-accession period. This obligation could not be avoided if Croatia were a full

member. However, the experience of the 10<sup>xvi</sup> new member states shows that screening and compliance monitoring is in certain areas deeper for “would-be” members than for members. For instance, the comparison of the state aid scoreboard and policy reports containing infringements (e.g. in the telecom sector) with Regular Reports show that the “would-be” members have to comply with the rules more strictly than member states.

Next, the EU launched some new policies and revised existing ones during the process of the preparations for enlargement. These include a revision of “internal” EU policies (such as the Common Agricultural Policy, CAP) and policies towards third countries (the Mediterranean countries, Russia, Ukraine, Commonwealth of Independent States (CIS) and transatlantic partners). Instruments of the policy towards neighboring countries include the creation of free trade zones and cumulation of rules of origin. It is expected that by 2010 EU will create a free-trade zone with Mediterranean countries in which cumulation of rules of origin will apply. So when Croatia joins the EU, it will have to allow free access to the domestic market from more countries – not only the EU member states. It will also have to be able to compete with competitive pressures in the market of member states, which will be increased by the effects of enlargement and EU policies – all (or almost all) neighboring countries will have free access to the EU market. Also, liberalization of Croatian trade policy towards Mediterranean countries and CIS will be one of the elements upon which alignment with the EU rules and also compliance with the second economic criterion will be assessed.

Furthermore, the EU will develop some policies not directly related to the enlargement. Croatia will have to adhere to them as well. They might include some constitutional agreements, financial rules (including issues such as budget and state aid) and competition policy issues.

So in the pre-accession period Croatia will have to follow developments in the EU. However, in alignment with EU policies, caution is needed. For experience has shown that Croatia’s membership in CEFTA was too short to bring any benefits,<sup>xvii</sup> while the arrangements achieved might be regarded as an obstacle in getting a “better deal” with the EU in negotiating revisions of the SAA in order to take account of the enlargement. That is, in order to take account of enlargement, some *technical adjustments* of the SAA were necessary. This led to the new protocol of the SAA (Protocol No. 7) being negotiated. Its

purpose is to adjust quotas to the enlarged EU. Technical adjustments were seen by the EU as simple math – adding the quotas defined by free trade agreements between Croatia and new member states to the quotas defined by the SAA. Croatia asked for an increase of quotas for quantities really imported from new members; quotas to CEFTA countries were not fully used, and not even defined to some countries, since they were not needed. Hence, technical adjustments, as seen by the EU, would mean increased quotas that would be used by the old member states and hence a further increase of Croatian imports from EU.

Finally, the EU is still developing, and can be considered as a moving target. Enlargement creates the need for further reforms within the EU and hence additional obligations of membership. However, it is not yet possible to identify how the enlargement affects the speed and direction of its movement.

### **Capacity of enlarged European Union to absorb new members**

The enlargement from 15 to 25 underlines the need for defining the EU from the inside by a Constitution and along its edges by the adoption of a strategy on the wider Europe and the neighborhood. These two issues can also shape the process of the enlargement in the future.

The financial framework for the next round of enlargement depends on its size and coherence. Namely, the capacity of the EU to take on new members depends on the capacity of the EU to manage and finance its policies. Institutional arrangement depends on whether this will be the last round, or some new rounds are likely to happen in the near future. This is closely connected with the question of the borders of Europe. According to the earlier mentioned Article 49 of the TEU, further EU expansion awaits debate on the ultimate geographic limits of the EU.<sup>xviii</sup> This is implicitly stated also by New Neighborhood Policy of the EU (European Commission, 2003b) which recognises that countries that *currently* do not have any perspective of membership in the EU might have such a perspective at a later stage. Which countries are “potential candidates” significantly influences capacity of the EU to absorb new members, which is one of the Copenhagen criteria. Institutional design for EU-28 (if Croatia is the only country in the next round of enlargement, and Bulgaria and Romania are included as part of this round of enlargement) is likely to be different from EU-29 (EU-

25 + Bulgaria + Romania + Croatia + Turkey), or EU of some 35, mostly small states (SAP countries, which are at present potential candidates: Albania, Bosnia and Herzegovina, Macedonia, Serbia, Montenegro and Kosovo).<sup>xix</sup>

Next, it is difficult to predict whether EU-25 can work with its present institutions. This makes the time horizon for future enlargements more distant. The Constitution should facilitate the functioning of the EU and enable subsequent enlargement(s). Without a constitutional framework it will be quite difficult to reach an institutional agreement on the participation of Croatian representatives in the EU institutions.

This implies that based on the EU's capacity to take on new members there are two basic scenarios for inclusion of Croatia into the EU. The first is the *fast inclusion scenario* based on an EU political decision and does not provide a "regular" framework for the institutional design of the enlarged EU. It implies that Croatia will be the only country included in the round of enlargement. Its size would allow the granting of the same number of representatives to the EU institutions as to countries of a similar size. However, this solution does not enable the same approach for the subsequent rounds of enlargement, decreases the credibility of the EU and indicates that votes of a small, individual member basically do not matter. For if the inclusion of Croatia were to decrease the power of some countries in decision-making, it would be politically very difficult to achieve the needed unanimity.

Therefore, we consider that the fast-track scenario is not very likely. The more *distant membership scenario* is based on the presumption that the "normal" institutional approach will be followed. This implies that the EU will have to digest this enlargement first, so that the next enlargement will not happen before a constitution is agreed upon and ratified.

The institutional package related to EU-accession can be negotiated for Croatia alone, for Croatia and Turkey, possibly Macedonia and other SAP countries. This does not imply that the whole "block" is going to enter the EU in unison. However, it is likely that the EU will design the institutional structure for SAP countries and Turkey in a "package". Namely, SAP countries are rather small, so their membership can cause additional problems in voting, disturbing the balance between *big* and *small* member states.

Considering Turkey as an EU member state would probably be of interest to the "big" countries, since their number and influence would grow. On the other hand, an increased number of EU member states

increases the need for harmonization of policies and negotiating positions, since the negotiating strength of each individual member state decreases as the total number of member states increases (Table 2).

*Table 2 Size of the European Union member states, Stabilisation and Association Process countries and Turkey*

	Area (1000 km <sup>2</sup> )		Population (mil)		GDP (billion USD)		GDP (USD per capita)
	Median	Average	Median	Average	Median	Average	
EU-15	132	216	10.0	25.3	251.6	594.9	21,192
New members	57	74	3.0	7.5	14.7	32.8	4,383
EU-25	79	159	9.0	18.2	13.1	370.1	18,392
SAP countries	51	53	4.2	5.0	4.4	7.7	1,537
Turkey		774		65.3		199.3	3,052

*Source: Boromisa (2004b - based on World Bank data for 2000)*

Table 2 illustrates how the average size of EU member states has shrunk as a result of the enlargement. While the average EU-15 member had a population of around 25 million and a GDP of almost 600 billion USD, the average member state of EU-25 has roughly 30% fewer inhabitants (18 million) and a 38% smaller GDP (i.e. 370 billion USD). For weighting the votes in the Council, the calculated median shows more. While half of the EU-15 countries had populations of over 10 million, in EU-25 more than half have over 9 million, which decreases the relative “weight” of the “big” countries. The SAP countries have populations of 5 million on average (4.2 median), so their inclusion would shift the balance further to the smaller countries.

To sum up, enlargement of the EU decreases its capacity to accept new members. The differences between the negotiating statuses of the candidates are correlated with the capacity of the EU to absorb them. In order to include representatives of new members in the EU institutions, an agreement and a new intergovernmental conference are needed. Hence, it would be more reasonable and efficient to initiate such a procedure for more than just one small country.

## **Economic impact of the enlargement**

The net economic impact of the first round of the Eastern enlargement is expected to be small and positive (for more, see e.g.

European Commission, 1997). The expected economic *impact for the new members* should be large and positive. The *impact on the old members* (EU-15) is expected to be limited. The GDP of the 10 new member states amounts in total to approximately 4% of the GDP of EU-15 (Eurostat, 2004), which illustrates why the impact on the economies of the EU-15 is expected to be marginal.

The prevailing *impact on third countries* is also expected to be limited, but unevenly distributed. It depends on the region, sector, as well as the timing and success of measures aimed at alleviating possible negative impacts of enlargement—such as creation of free trade zones, which is the main instrument of the SAP and New Neighborhood Policy. The impact of enlargement is expected to be bigger in neighboring regions, and negative in traditional industries and agriculture (for more about this see Gros, Crum and Turmann, 2004; Bayar, 1998; Frandsen, Jensen and Vanzetti, 1998; European Commission, 1997; Boromisa, 2004b).<sup>xx</sup>

Croatia is a neighboring economy, in which traditional industries are quite important. Hence, negative effects of enlargement can be expected. On the other hand, the EU enlargement is taking place during an extremely eventful period for Croatia: it has recently joined the WTO, signed the SAA and regional free trade arrangements (with CEFTA, EFTA and Western Balkans). These processes should help alleviating possible negative effects of the EU enlargement.

Hence, to estimate whether these processes will have a positive or negative effect some quantification is needed. Our quantification is based on two analyses – on the level of the economy as a whole and a sector-specific analysis. Both analyses, whose results are presented below, quantify trade effects of the EU enlargement and establishment of free trade zone with the EU.

At the level of economy as a whole we first estimate the *general* trade effects of the EU enlargement, i.e. the impact of enlargement on extra- and intra-EU trade. Next, we project the distribution and relevance of these effects for Croatia. Third, we estimate the effects of the establishment of a free trade zone with the enlarged EU. Finally we estimate the prevailing effect of establishment of a free trade zone between Croatia and the EU and the EU enlargement.

Sector-specific analysis includes an estimate of the impact of sector-specific trade barriers and an analysis of the position of Croatian exporters on the market of old and new EU member states based on several indices (e.g. revealed comparative advantages, terms of trade, quality gap).

*General* trade effects of the enlargement are classified as trade creation effect (increase of intra-EU trade) and trade diversion effect (decrease of extra-EU trade). We estimated that the EU enlargement could lead to increase of intra-EU trade (trade creation effect) 1.73%, reference value being “statistical” intra-EU trade. Trade creation is induced by elimination of trade barriers which create costs. We estimated trade diversion, i.e. decrease of extra-EU trade, 0.18% of the statistical value (for more see Boromisa 2004b). The results are in line with other studies that show that the impact of enlargement is likely to be limited (e.g. Baldwin, Francois and Portes, 1997; Keuschnigg and Kohler, 1999; Lejour, Mooij and Nahuis, 2001). However, these limited effects of enlargement might be very significant for Croatia, due its size compared to the EU. This can be illustrated by the fact that the estimated trade diversion effect (0.18% of statistical extra-EU trade after enlargement) is equivalent to 40% of the total exports of Croatia to EU-15. Hence, what is from the EU perspective a “small” trade diversion effect can seriously jeopardize Croatian exporters.

Based on the decrease of trade costs within the EU we estimate trade diversion effect of enlargement on Croatia as a 5.5% decrease of Croatian exports to the EU. Decreased trade costs (and prices) are expected to cause an increase of imports from the EU of 2.9%, the reference value being “statistical” exports and imports to EU-25 (Table 3).

Using the same approach (decrease of trade costs between the enlarged EU and Croatia) we estimate the impact of establishment of free trade with the EU-25 on trade between Croatia and EU as a 8.5% increase of imports and 2.5% of exports (Table 3). This result indicates that enlargement will intensify the effects of the establishment of a free trade zone. Previous research showed the establishment of free trade zone will lead to an increase of exports to the EU-15 of ca 2%, and an increase of imports by ca 7-8% (Kersan-Škabić, 2001; Samardžija, Staničić and Nikić, 2000; Madžarević, Šonje and Jurlin, 1997).

The estimated effects of enlargement and the establishment of a free trade zone taken together show a further increase in the short-term impact of the establishment of a free trade zone with the EU: the expected prevailing effect is a 3% decrease of exports (compared with statistical value of exports to EU-25) and an 11.4% increase of imports from EU-25 (compared with statistical imports from EU-25), as shown in Table 3.

*Table 3 Short-term trade effects of enlargement and implementation of the Stabilization and Association Agreement on trade between Croatia and EU-25. Estimate on the level of economy as a whole*

	Enlargement impact	SAA	Total (impact of SAA and the enlargement)
Export growth (reference value statistical export) %	-5.5	2.5	-3.0
Import growth (reference value statistical import) %	2.9	8.5	11.4

Source: Boromisa (2004b)

This analysis shows that enlargement is likely to intensify the effects of the establishment of a free trade zone and to increase the adjustment costs. The establishment of a free trade zone will also create the potential for exploiting better access to a bigger market. The projected trade creation effect (1.73% of intra-EU trade) is a result of increased demand in the new member states, which equals 9.5 times Croatian exports to these countries, while increased demand in the EU-15 is 1.05 times greater than Croatian exports to the EU-15. At the level of EU-25 increased demand is 2.73 times greater than statistical export to EU-25. Exploiting just a small part of this potential can have a significant positive impact on Croatia's trade balance and economy as a whole, but exploiting this potential is limited by the Croatian production and export structure.

A *sector specific* analysis of Croatian economy shows that in open sectors production structure corresponds to the export structure<sup>xxi</sup>. However, this is not in line with the comparative advantages of Croatian producers. Hence, we estimated (summarized results are presented in Table 4) that the prevailing impact of implementation of SAA and the establishment of a free trade zone will lead to increased imports from the enlarged EU, while integration within the EU will cause fierce competition within the EU and some trade diversion that could be felt by Croatian exporters.

It might be concluded that the potential for *trade expansion* towards the enlarged EU for Croatian producers and exporters is in the short-run limited by their production capacities, which do not correspond with demand on the EU market.<sup>xxii</sup> Generally, demand for sophisticated products on the EU market is increasing, while difficulties



can face producers of traditional products. Bearing in mind the Croatian export structure (sectors that create 5% of GDP contribute to almost 60% exports and export oriented sectors are traditional ones – textile, clothing, wood) it is likely that negative effects will prevail. This is the result of slow structural changes in Croatia, which during the transition period have been slower than in the new EU member states (IMF, 2000). The economic growth in Croatia in the transition period was boosted by domestic consumption. Hence, liberalized access to the Croatian domestic market, caused by implementation of SAA, is increasing competitive pressure on the domestic market. In the enlarged EU trade barriers between individual member states are being abolished. This decreases trade costs and leads to increasing competitive pressure on the EU market. EU enlargement and the establishment of a free trade zone are increasing competitive pressures in the most important markets for Croatian producers (domestic market and the EU market), so in the short run significant adjustment costs are to be expected. The results of the sector-specific analysis show that the obstacle to keeping up exports to the (enlarged) EU is production (and export) structure, and not the integration process as such.

*Table 4 Sectoral estimates of short term trade effects of enlargement and implementation of Stabilization and Association Agreement*

	Enlargement impact	SAA	Total (impact of SAA and the enlargement)
Export growth (reference value statistical export) %	-8.5	3.0	-5.5
Import growth (reference value statistical import) %	–*	7.9	7.9

*\* This estimate analyses the position of 98 products originating from Croatia on the EU markets (divided into two parts-old member state and new member state markets) and of products originating from these two markets in Croatia. The increases in imports from old and new member states were estimated separately, because the trade barriers applied by Croatia towards products deriving from the two separate groups were not the same. Changes in Croatian trade barriers to goods originating in the old members can be regarded as an effect of the implementation of the SAA, and changes with respect to tariff barriers applied to the exports of new members a result of the alignment of free trade agreements with the SAA. In order to make the comparison simple, the same reference value, statistical imports from EU 25, was used. This is the reason why the effects have been attributed to the implementation of the SAA.*

*Source: Boromisa (2004b)*

Restructuring is transition-related and should create conditions for sustainable growth. Also, the adjustment costs can be regarded as a preparation for inclusion into full membership, as building Croatia's capacity to cope with the competitive pressures of the internal market. This requires that the underlying economic environment is favorable and that the Croatian economy has flexibility and a sufficient level of human and physical capital, including infrastructure. In their absence, competitive pressures are likely to be considered too intense by some groups of society (which are likely to be affected by adjustment costs) and there might be a call for protective measures, which, if implemented, would undermine the single market. This could be seen from the EU side as a deficiency in meeting the second economic membership criteria, so such issues should be dealt with in the short run.

Sensitivity analysis of basic presumptions shows that further integration within the EU (like a further decrease of barriers within the EU, resulting for instance, from the introduction of the euro), or change of price elasticity towards products from third countries intensifies the impacts of enlargement. A change of perception of the domestic (EU) product also intensifies this effect, so in the longer run can make it more difficult to sell on the EU market.

On the other hand, the potential for exploiting the gains of integration (within the EU, e.g. for members, and towards the EU – e.g. for third countries) should increase over time. Whether this potential will actually be exploited depends on the capacity of firms and domestic institutions in the individual state and hence its own growth prospects. For a small and open economy (such as Croatia) gradual integration with a developed, neighboring and big economy (implementation of the SAA), creates the potential for exploiting the positive effects of such arrangement (Schiff and Winters, 1998). The potential for exploiting these positive effects of integration grows with the size of the integration. Hence, such a potential is estimated to be greater towards the enlarged EU than the potential estimated towards the EU-15 and CEFTA separately (more about this see Kersan-Škabić, 2001; Boromisa, 2004b).

Regional economic integration (with EU, CEFTA, Western Balkans) and enhanced cooperation with Mediterranean countries and CIS can help to make the adjustment costs tolerable and thus facilitate integration into the EU market (through re-directing some exports to these markets). However, this should be regarded as an accompanying measure. Integration into the EU is, due its size, level of development, geographic position and already established economic links with Croatia, economically the best option.

## Next round(s) of enlargement

Croatia is likely to start accession negotiations in 2005, and will probably meet membership criteria to be included in the second round of Eastern enlargement. But it is not yet defined when this round will take place and which countries will be included.

So far, apart from Bulgaria and Romania, which are considered to be a part of the first round of Eastern enlargement, there are only two candidates: Croatia and Turkey, while SAP countries are potential candidates.

In December 2004 European Council concluded that Turkey sufficiently fulfils Copenhagen political criteria to open accession negotiations provided it brings into force specific pieces of legislation. It invited Commission to prepare necessary framework proposals with a view to opening negotiations on 3 October 2005 (European Council 2004b). Opening of negotiations, however, does not set the timeframe for membership nor answers the remaining institutional, financial or policy issues from the EU side. Experience from the first round of Eastern enlargement shows that a later opening of negotiations does not necessarily mean later membership (e.g. Slovakia, Lithuania, Latvia).

The next round(s) of the Eastern enlargement will be smaller than the current expansion. The sheer size of the last round of enlargement, as compared with that in which Croatia is likely to be included, shows that the EU will have much more capacity and experience to monitor progress than it had in the previous enlargement round.

The distant time horizon for full membership raises two issues of general significance: first, how the EU can give sufficient substance to the association process to keep it politically motivating, and second, whether and how the EU constitution and institutions can be made capable of absorbing many more small states, with the total rising maybe to 30 or 35 member states (more about these issues see Emerson, 2002; 2003)?

## CASE OF CROATIA: WHAT SCENARIO FOR THE FUTURE?

Based on the extent to the commitment to Europe and on EU political will, four alternative scenarios for the future integration process, labeled as progression, regression, compression and secession

could be envisaged (Table 5). They do not answer the basic question of when Croatia is going to be included into the EU, but show the way that is the fastest.

Table 5 Scenarios for the future

		Croatia: extent of commitment to Europe	
		High	Low
EU political will	High	Progression	Compression
	Low	Regression	Secession

Source: According to Grimm (2004)

The *compression scenario* is basic scenario, identified earlier as distant membership scenario. Although the EU is willing to enlarge, the movement to a Constitution and new institutional solutions remains slow, the focus on regionalism and blocks is continued, accession negotiations continue, while policy coherence remains distant.

The *progression scenario* is based on the presumption that the EU accepts (i.e. all member states ratify) the constitution and vigorously supports the integration process. The focus is shifted from regionalism and blocks, so the SAP is individualized. Croatia's institutional capacity is created and remaining difficulties are dealt with.

In the *regression scenario* a consensus around greater Europeanization is found, but negotiations falter. There is little support for radical opening up of the EU.

In the *secession scenario* lip service is paid to Europe, but in practice no progress is made, financial perspective do not allow for further enlargement, member states increasingly challenge the decisions and orientations of the Commission, re-nationalising the EU is discussed, and bilateral agreements acquire more prominence.

By deciding to convene a bilateral intergovernmental conference with Croatia early in 2005 in order to begin negotiations, the European Council confirmed the principle of eligibility for all European democracies (European Council, 2004a). This can be regarded as indicating a high level of EU political will, so the progression scenario is possible if Croatia does its part. The progression scenario is not the same as the fast inclusion scenario, which we mentioned earlier, arguing that it is not very likely. Progression denotes the fastest possible, but it does not really mean fast (short run) membership in the EU.<sup>xxiii</sup> Identifying the progression scenario with fast inclusion into the EU is the result of insufficient understanding of EU procedures and policies.

Confusing the progression with the fast inclusion scenario might lead to another misunderstanding – that the EU’s political will is fading, so that the progression scenario is not being realized, rather the regression scenario. Lots of reforms in Croatia, including not popular ones, are labeled “European”. So perception is that Croatia is doing its best, but the EU is just not willing to accept us. Such a perception, coupled with the lack of a clear date of accession might slow down reform implementation, in spite of the formal consensus around greater Europeanisation.

This simplified analysis of the complex process of the EU integration (which therefore should be viewed as tentative exercise) illustrates that it is quite simple to get from progression to secession. The path from progression to secession is highly dependent on information strategy and perception of the process of European integration. Simplified domestic policy will play a crucial role in the process of integration.

Labeling unpopular reforms as European, which is not always the truth, and simultaneously announcing EU membership as a Croatian “strategic goal” gives confusing signals. Why should Croatia want to be included into the EU while it creates costs? What is in it for Croatia, and when will the integration process bring some benefits?

It seems that no one is ready to say that Croatia needs reforms anyway. Including unpopular ones. But it is politically easier to say that Croatia needs them because the EU asked for them (or IMF, World Bank and other “bad guys”).

Still, it should be estimated how much membership can cost, and which sequencing of reforms is needed. Croatia should know its negotiating position – if EU membership is a Croatian strategic goal, is there anything to negotiate? Also, it should be clear what price Croatia is ready to pay for full membership (which could be distant). The issues already raised include agriculture, fisheries and eco-zones. The border with Slovenia has been recently mentioned (especially before the Slovenian elections) in the context of Slovenian support for Croatia’s integration into the EU. In the future new issues can arise, such as national treatment in public procurement and granting concessions (e.g. water but perhaps also gas and oil once Croatian oil company INA is privatised more than 50%, which should be, according to the INA Privatisation Act, upon accession to the EU).

Hence, although full membership is according to the so-far available analyses economically the best option, Croatia should be open

for “virtual membership” possibilities, such as political integration, economic integration and decision shaping without full membership.

Some of the models and sectors for possible economic integration and institutional cooperation with the EU are given in Box 1.

**Box 1 Possible models of virtual European Union membership**

1. Economic dimension

1.1. Trade and markets

Tariff free trade

Customs union

Single market (and avoiding hub and spoke relations)

1.2. Monetary regime

Semi-fixed parity with euro

Fixed exchange rate with euro, currency board regime

Euro as parallel currency in private sector

Full euroisation

2. Institutional dimension

Political dialogue

Participation in decision-shaping, but not decision-taking\*

Implicit participation in decision making\*\*

Observer status in EU bodies, e.g. in Economic and Social Committee, Committee of the Regions

Recognizing the authority of some EU institutions, e.g. European Court of Justice

\* Active observers, as 10 new members in pre-accession period.

\*\* e. g. Council of Ministers: A member state chosen by the associated state or entity may be mandated to speak on its behalf. In the voting of the Council of Ministers under the double majority proposed by the Constitution, the mandated member state may cast the population vote of the associated state or entity separately. A representative of the associated state or entity may attend as observer within the delegation of the mandated member state in open legislative sessions European Parliament. Inclusion in a neighboring constituency of a member state (for a micro state/entity), or an observer or full member (where population reaches average constituency size). A Commissioner in the European Commission will have relations with the associated states and entities in his portfolio of tasks.

Source: According to Emerson (2002; 2003)

As Box 1 shows, there are various options and their combinations for participating in the EU. The benefits of virtual membership include various sequencings of reforms. However, this implies that sufficient analyses exist, so the best option can be chosen. Also, for a small

country, virtual membership decreases costs, especially these in limited human capital. For instance, full euroisation would mean fully taking part in the euro area, but with no seat on the Governing Council of the European Central Bank; and possibility for limited minting of euro coins (like the Monaco euro).

## CONCLUSION AND RECOMMENDATIONS

After the last enlargement, the EU is for a small and neighboring country, such as Croatia, even more important than before. The importance of other regional integrations has decreased. Therefore, full EU membership is probably the best long-term solution.

Croatia is likely to be included in the second wave of Eastern EU enlargement, but that wave might be more distant than officially expected by the Government. The time horizon of inclusion into the EU does matter. Hence, alternative options should be considered for the “pre-in” phase.

Also, declaring full membership as a strategic goal and ultimate objective can jeopardize the Croatian negotiating position and open space for increased pressure from some member states. The decision should be made: is there anything “more strategic” than the EU (such as fisheries and oil in Norway) and how much are we ready to pay for EU membership without knowing its timeframe?

Hence, to strengthen Croatia’s negotiating position alternative, “virtual” membership options should be taken into consideration, such as participation in the internal market (such as European Economic Area – EEA membership, like Norway, Iceland, Switzerland) and following the work of the EU institutions as active observers. Virtual membership options might be in the short run economically more viable than fast full membership.<sup>xxiv</sup>

Raising the public awareness that there is a life outside the EU and that reforms are needed for successful transition and not because of the EU might help in keeping the pace of reforms and enable the meeting of membership criteria. Meeting the membership criteria should be regarded as Europeanisation, and hence as a goal and not condition.<sup>xxv</sup>

The impact of economic integration into the enlarged EU (thorough implementation of SAA) is expected to be greater than the impact of integration into the EU-15. For the potential for exploiting the positive effects of simplified access to a large market grows with the growth

of the market. This potential is greater in new members than in the EU-15. However, the possibilities for exploiting this potential by Croatian producers are limited by production structure and adaptability of firms (i.e. by the ability to fulfil the second economic membership criterion). In order to exploit the positive effects of integration, reforms are needed. The reforms require the toleration of significant adjustment costs, especially in the short run. The enlargement intensifies this effect, so SAA implementation coupled with the impact of enlargement increases the pressure for reforms. Reforms are transition-related, and their result should bring benefits (enable sustainable growth). These reforms would have been needed even if the EU had not enlarged, and if the Croatia had not signed the SAA. Enlargement and establishment of a free trade zone hence highlight the need for reforms and might speed them up. In this context, the enlargement and the implementation of SAA can be regarded as beneficial processes for the Croatian economy, in spite of the fact that they create adjustment costs.

Hence, recommendations can be summarized as follows:

- examine the time frame for integration, i.e. how fast is it possible?
- identify alternative options for integration in the “pre-in” phase;
- define any strategic interests there might be that are unconnected with membership in the EU;
- in sequencing reforms consider the possible timeframe for EU membership;
- raise public awareness that some of the EU-related reforms are also transition-related (i.e. necessary anyway) and that by entering the EU reforms (and related costs) do not stop.

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- i *The first round of Eastern enlargement in this paper denotes the enlargement process that includes 10 countries of Central and Eastern Europe as well as Cyprus and Malta. This means that Romania and Bulgaria are, in line with conclusions of the Salonika European Council (2003) regarded as the part of the same round of enlargement.*
  - ii *Interim Agreement enables the application of the provisions of the Stabilization and Association Agreement (SAA) that are under the competence of the Community (such as establishment of a free trade zone). This enables gradual integration towards the EU in the period before ratification process is finalized.*
  - iii *More about membership criteria, see Boromisa (2004a:169-173).*
  - iv *This progress is monitored and evaluated regularly once a year by the European Commission and its main findings are published in Regular Reports. In the period after completing negotiations and before signing the Accession Treaty, candidates were also monitored. The main findings were published in the Comprehensive*



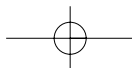
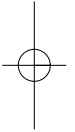
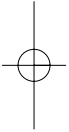
- Monitoring Report of the European Commission on the State of Preparedness for EU Membership of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia (European Commission, 2004c).*
- v *This is confirmed by conclusions of the European Councils in Copenhagen (2002), Salonika (2003), and Brussels (2004). The Salonika Council (2003) stated that "the pace of negotiations (with Bulgaria and Romania) will be maintained, and these will continue on the same basis and principles that applied to the ten acceding states with each candidate judged on its own merits. Building on significant progress achieved, the Union supports Bulgaria and Romania in their efforts to achieve the objective of concluding negotiations in 2004, and invites them to step up their preparations on the ground. Discussions or agreement on future policy reforms, or the new financial perspective, will neither impede the pursuit and conclusion of accession negotiations nor be prejudged by the outcome of these negotiations." The Copenhagen Council (2002) recalled its decision from Helsinki (1999) that Turkey is a "candidate state destined to join the Union on the basis of the same criteria as applied to the other candidate states". When Croatia was given the candidate status, the Council in Brussels stated following "The European Council... confirms that the negotiations will be based on Croatia's own merits and that the pace of accession will depend solely on Croatia's progress in meeting the requirements for membership". So the European Council confirms that the criteria will be the same, but differences in wording might lead to conclusion that it acknowledges that the EU is a moving target and that the timeframe does matter.*
- vi *This is evaluated upon functioning of the institutions designed to respect liberty, democracy and human rights (parliament, executive, judiciary). They have to be stable and guarantee the rule of law, i.e. they protect individual rights and freedom in practice.*
- vii *The European Commission evaluates the effectiveness of a market economy on the basis of following: the equilibrium between supply and demand established by the free interplay of market forces (prices and trade liberalization); absence of significant barriers to market entry (establishment of new firms) and exit (bankruptcies, liquidations); the legal system, including the regulation of property rights; macro-economic stability achieved, including price stability, sustainable public finances and external accounts; the existence of broad consensus about the essentials of economic policy and sufficiently developed financial sector to channel savings towards productive investments.*
- viii *This date corresponds with the planned date for finalizing preparations in Croatia. Originally, it was targeted so as to catch up Bulgaria and Romania in the "next" round of enlargement.*
- ix *SAP conditions include conditions defined in the so-called "regional approach", i.e. conditions defined by the Council in its Conclusions of 29 April 1997 and 21-22 June 1999, the content of the final declaration of the Zagreb Summit of 24 November 2000 and Salonika agenda. They include co-operation with the International Criminal Tribunal for the Former Yugoslavia (ICTY), regional co-operation and other related issues (such as refugee return, fight against corruption etc).*
- x *Such an approach can be explained by the fact that in the period before accession significant progress was made in terms of negative integration, i.e. elimination of customs duties and quantitative restrictions. Effects of other integration policies are likely to be felt in a longer period. A similar approach is also used in numerous studies, such as, Baldwin, Francois and Portes, 1997; Keuschingg and Kohler,*

- 1999; European Commission, 1997; Gros, Crum and Turmann, 2004. For summarized findings of these approaches see Boromisa (2004b:14).
- xi Integration into the EU means inclusion into the internal market, i.e. free movement of goods, persons, services and capital. However, in this paper we examine only product market integration. Removal of trade barriers means dismantling of existing barriers (e.g. tariffs, quotas, voluntary export restrictions) and harmonization of policies (e.g. agriculture, competition, trade and industrial).
- xii Negative integration denotes the removal of discrimination in economic rules and policies, while positive integration refers to the transfer to common institutions. For more see Pelkmans (1997).
- xiii Ex ante estimation of potential economic effects of enlargement is dealt with under the heading *Economic impact of enlargement*.
- xiv This part of the paper relies on calculations in my Ph. D. thesis, while the data used are mainly Eurostat, and to the lesser extent IMF and Croatian Bureau of Statistics. If no source is explicitly stated, the default is Boromisa (2004b).
- xv One of the indices that can be used for measuring intra-industry trade (IIT) is the Grubell-Lloyd index (GL) (more about IIT indices see Gullstrand, 2002). The GL index, calculated on the two-digit level of combined nomenclature, for Croatia towards EU-15 was 0.46, while towards the EU-25 is 0.5 (Boromisa, 2004b). IIT towards the EU-25 is greater than towards EU-15. Volume and nature of goods traded is one of the indices used to estimate readiness to meet economic membership criteria. Hence, according to this index, after the enlargement Croatia meets membership criteria better.
- xvi Issue of the size of the next enlargement round is dealt with under heading *Capacity of enlarged European Union to absorb new members*.
- xvii This concerns multilateralization of individual free trade agreements.
- xviii Similar wording is also in the draft Treaty establishing a Constitution for Europe (COREPER, 2004), whose provisions follow the procedure established in the fifth round of enlargement (Article I-57).
- xix By 35 I do not mean to imply that Kosovo will become sovereign state nor that Serbia and Montenegro will create two different states. This number is just an illustration of the possible total number of member states. It should be noted that Iceland, Lichtenstein, Norway and Switzerland may also apply for membership. Ukraine, Belarus, Moldova and some Black Sea countries, as well as Russia may also eventually become candidates.
- xx In order to minimize possible negative effects of the enlargement, the EU is fostering regional integration in neighboring regions (Mediterranean countries, Russia, Ukraine, CIS) and by doing so is intensifying competition on these markets and as well in the EU market. Such a development, if Croatia does not intensify its efforts for economic reform, can significantly jeopardize its competitiveness on these markets and EU market.
- xxi Openness is defined as share of trade/proportion of GDP. Out of 17 sectors according to national classification, five are subject to international trade and their share in GDP has in the period 1995-2001 decreased from 31 to 28%. Percentage of exports in GDP in the same period decreased from 49 to 24%.
- xxii This can be illustrated by unit export price defined as value of total exports (in euros) over its quantity (in kg).
- xxiii We would not speculate on date of accession, since it depends on too many factors, some of which are identified here. For the dates by which we consider Croatia is likely to be evaluated by the European Commission as capable of meeting member-



56

- ship criteria see, for instance Boromisa (2002). It should also be noted that the risk of delays in the ratification procedure rises with the number of the EU member states (i.e. number of national parliaments that have to ratify the accession treaty).*
- xxiv *This statement relies on the fact that there is no obligation to contribute to the EU budget before full membership. On the other hand, pre-accession funds (such as TEMPUS, CARDS) should be open for participants from Croatia. This should be analyzed in more detail.*
- xxv *However, one should be aware that some of the necessary, but politically tough decisions are “justified” as requirements for the EU. If other options are considered, new “excuses” for unpopular decisions such as decreasing public expenditure are to be found. This might lead to the government losing popularity, which is not the favorite option of (any) government.*



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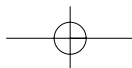
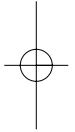
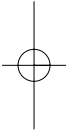
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## Chapter 3

# TRADE INTEGRATION AND CROATIAN ACCESSION TO THE EUROPEAN UNION

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## ABSTRACT

This paper assesses the trade criteria for EU membership and the extent to which Croatia fulfills those criteria. The relationship between trade criteria and the economic ability to pursue EU accession is discussed and a gravity model of Croatian trade is constructed in order to measure the level of trade diversification achieved in an objective manner. Significant trade biases towards the former Yugoslav republics are found as well as an emerging bias in imports from Central and Eastern European countries (CEEC). Moreover, the process of trade liberalization that was promoted recently did in general not significantly contribute to trade diversification towards countries with which preferential trade agreements had recently been concluded, rather reinforced existing biases, although there are some differences between export and import flows. In order to mitigate the consequences of delays in the integration processes, reduce long-term costs of trade restructuring and encourage the trade

*\* The views expressed in the paper do not necessarily reflect the views of the Croatian National Bank. The authors would like to thank the referees who anonymously reviewed this paper.*



integration with the EU necessary for successful accession, Croatia should seek to eliminate the remaining institutional barriers to trade with the EU. Also, the continuation and faster implementation of structural reforms are necessary preconditions for an increase of openness in trade.

**Key words:**

trade integration, preferential trade agreements, gravity analysis, Croatia

## INTRODUCTION

The fall of the Iron Curtain and the subsequent integration of CEEC into the EU economy can probably best be traced through the dynamics of trade integration. The conclusion of Association agreements<sup>i</sup> in mid-1990s liberalized trade among them and created the opportunity for the expansion of bilateral trade. The transition countries that were the fastest and most successful in implementing economic reforms also managed to make the best use of the new opportunities to expand trade. However, the level of trade integration was not just an indicator of progress in economic integration; the European Commission also used the level of trade integration achieved, amongst other things, as an indicator of the ability to pursue further integration into the EU. Moreover, some researchers used measures of trade integration in order to estimate in an objective manner whether candidates were fulfilling EU accession criteria. However, trade integration was not always a success story. Fears of rapid expansion of labor-intensive imports (so called “sensitive products”) from the CEEC and resulting employment losses in labor-intensive industries prompted the EU to keep barriers on imports of sensitive products. Thus EU policies towards the candidates did not always support rapid and complete integration.

This paper aims to identify the progress Croatia has made in economic integration with the EU. Croatian progress in trade integration requires particularly careful assessment because of the importance of trade integration with the EU for the overall economic integration of the CEEC. The consequences of delays in the integration processes on the part of Croatia are discussed and proposals for policies to reduce the biases identified in Croatian trade patterns are provided as well. In the first chapter the economic criteria for EU accession and the role of trade integration in fulfilling those criteria are discussed. In the following chapter

trade integration is placed within the framework of transition. The role of trade integration in the transition of the CEEC is explored using standard indicators of trade integration with the old EU member states. In addition to this, the results of more sophisticated studies based on gravity analysis of trade flows are presented. Further on, a gravity model of trade flows is utilized in order to assess the trade integration of Croatia with the EU and the biases that characterize Croatian foreign trade. Finally, we conclude by proposing policies to reduce identified biases.

## **TRADE INTEGRATION AND ECONOMIC CRITERIA FOR EUROPEAN UNION ACCESSION**

The European Council in Copenhagen in 1993 decided on a number of criteria for accession to be met by applicant countries. These “Copenhagen criteria” constitute political and economic requirements for membership and requirement of the ability to assume obligations arising from membership or institutional capacity for membership. Economic criteria are defined as “the existence of a functioning market economy” and “the capacity to cope with competitive pressures and market forces within the Union” (European Commission, 2001). Fulfillment of the first criterion, the existence of a functioning market economy, is necessary before the Council can make a positive decision on accession, based on the opinion of the Commission, while it is important that the second criterion, if not yet fulfilled, can be expected in the near future, between the positive decision taking place and the actual moment of accession.

Although straightforward interpretation of the economic criteria might envisage an examination of trade integration between potential candidates and the Union, the Commission actually seeks for a mixture of different, more and less measurable, characteristics of the candidates’ economies. Concretely, in the first economic criterion, the Commission seeks to assess whether (1) an equilibrium between demand and supply has been established by the free interplay of market forces and whether prices, as well as trade, are liberalized; (2) significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent; (3) the legal system, including the regulation of property rights, is in place, with laws and contracts being enforce-

able; (4) macroeconomic stability has been achieved, including adequate price stability and sustainable public finances and external accounts; (5) there is a broad consensus about the essentials of economic policy; and finally (6) the financial sector is developed sufficiently well to channel savings towards productive investment. The ability to cope with the competitive pressures within the Union is a stronger criterion than the existence of a functioning market economy. It assumes (1) the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability, which is the first requirement for the fulfillment of that criterion. In addition to this, the second criterion assesses (2) the existence of a sufficient amount, at an appropriate cost, of human and physical capital, including infrastructure (energy supply, telecommunications, transport, etc.), education and research, and future developments in this field; (3) the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aid, support for Small and Medium-sized Enterprises, etc.; (4) the degree and the pace of trade integration a country achieves with the Union before enlargement (this applies to both the volume and the nature of goods already traded with member states); (5) the proportion of small firms, partly because small firms 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, 2001).

As the Commission assesses eleven listed conditions in a subjective manner, its opinions have been subject to criticisms. This subjectivity is evident since the final verdict is not clear until one gets to the conclusion of the Commission's opinion. Nilsson (2000) tries to formulate economic criteria for EU accession more objectively. In accordance with the definition employed by the Commission, Nilsson interprets the Copenhagen criteria as a high level of trade integration. Attainment of a sufficiently high level of trade integration, according to Nilsson, at the same time means successful penetration of the markets of Western European countries and therefore the ability to withstand competitive pressures on those markets. The Commission assesses the level of trade integration within the second economic criterion, or the ability to cope with the competitive pressures within the Union. However, it is only one of several indicators Commission uses vaguely to describe fulfillment of the required criteria. In order to avoid subjective judgment on sufficiency or insufficiency of trade integration, Nilsson utilizes the gravity approach to the analysis of trade flows in

order to derive trade potentials. Nilsson then compares trade potentials inferred from the gravity analysis with the actual trade level (see Box 1 for detailed elaboration of the gravity approach).

The following chapter elaborates why it is possible to use the difference between the actual trade flows and trade potentials as an indicator of progress in transition and the ability to integrate successfully into the EU. Further on, the results of studies that use the gravity approach to assess the level and evolution of trade integration between CEEC and the EU from the period preceding the transition until the late 1990s are presented. The gravity approach has some serious limitations and it is therefore not possible to rely on that approach only in order to draw a complete picture of the competitiveness of the economy, especially if there are imbalances between merchandise exports and imports, as there are in the case of Croatia<sup>ii</sup>. Therefore, other methods are sometimes employed in order to evaluate the competitiveness of the economy, such as comparative advantages revealed, indicators of sectoral concentration and differentiation of trade (or trade specialization) and indicators of intra-industry and inter-industry trade (Astrov, 2001).

#### **Box 1 The gravity approach to the analysis of trade flow**

Gravity models take care of some open issues arising from the trade openness and trade pattern comparisons that are routinely used by the European Commission in their assessments and it is therefore quite a sophisticated approach. Gravity models utilize economic potentials and trading costs, usually approximated with geographic distances, in an analysis of bilateral trade flows or in order to estimate trade potentials between pairs of countries. A gravity model is usually estimated over a pool of countries for a number of years using cross-section or panel methods. However, because we are solely interested in the pattern of Croatian trade, we shall rely on a single-country equation. A single-country specification, apart from serving our aim well, also avoids some troubling specification problems that arise in pooled estimations. First, differences in the relative remoteness of trading partners produce systemic biases that depend on the location of a specific country (Brenton and Di Mauro, 1998). Furthermore, the issue of heterogeneity of the countries may also be alleviated with a single-country specification, which is the reason some studies use such specifications. The gravity equation that we estimate, in its simplest form, is the following semi-log specification:

$$TR_i = \beta_0 + \beta_1 BDP_i + \beta_2 UDALJ_i + \sum_{jk} \gamma_{jk} D_{ik}$$

where  $TR_i$  stands for the natural logarithm of the trade flow<sup>iii</sup> between the Croatia and country  $i$ ,  $GDP_i$  for the natural logarithm of the gross domestic product of the country  $i$ , measured at exchange rate parity and  $DIST_i$  for the distance between Zagreb and the capital of country  $i$ . Using road distances would probably be more justified than using air distances because most goods are transported to Croatia by the road, but that would exclude overseas countries and therefore significantly reduce the number of observations. Finally,  $D_{ik}$  stands for dummies for different groups of trade partners (old EU member states, CEEC<sup>iv</sup> and former Yugoslav republics, individually), while other studies in this field use those variables also to isolate the impact of preferential trade agreements, adjacency or language similarity, which decrease the costs of engaging in international trade.

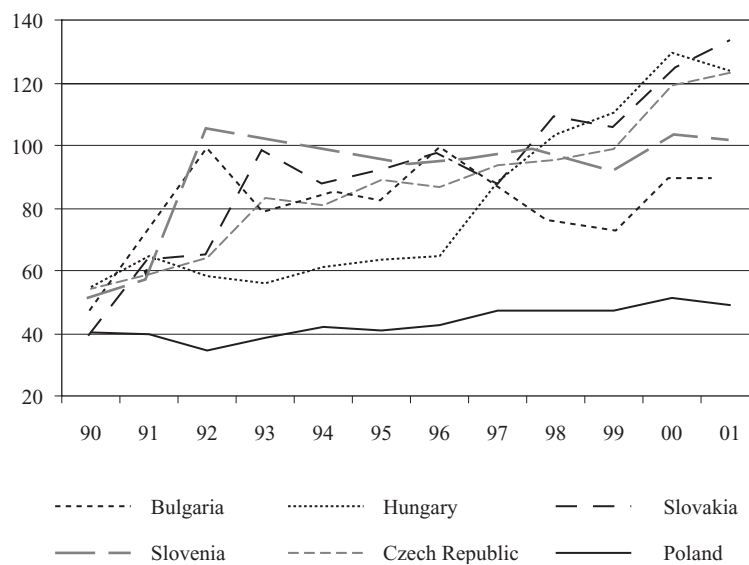
The gravity approach was launched as a more or less “atheoretical” approach to the analysis of trade flows. However, the idea of using economic potentials and trading costs in an analysis of bilateral trade flows proved to have deeper theoretical roots than was thought at first. Frankel (1997) surveys literature that tried to root the gravity approach in different theoretical rationales, the Heckscher-Ohlin model as well as the theory of imperfect substitutes. The establishment of the theoretical foundations of the gravity approach also contributed to some extensions of the model, an important one being the inclusion of “similarity” or “dissimilarity” variables to test for the relevance of different trade theories. Although compatible with the range of trade theories, the gravity approach remains unable to predict trade structure – a composition of the goods a country is supposed to import and export. In order to get an answer to that question, one has to look into the underlying theory of trade.

## TRANSITION AND TRADE INTEGRATION

At the onset of the transition, three distinct forces were shaping the trade pattern of a typical transition country. First, policies of stabilization, liberalization and privatization removed most of the existing barriers to their international trade and made possible an increase in trade openness. Further on, the collapse of the Council for Mutual Economic Assistance (COMECON), a trade block comprising the Soviet Union and the CEEC, contributed to the creation of a new economic geography and diversification of the excess trade that existed

within that trade block. Finally, the dissolution of multi-national states like the USSR, the Czech Republic and Yugoslavia, immediately increased the openness of the new countries by turning what had previously constituted internal trade into international trade. However, the creation of borders and the barriers they create worked in the opposite direction. New borders decreased the level of trade between the newly independent states, if the formerly internal trade is also considered<sup>v</sup>.

Figure 1 Trade openness ratios of selected transition countries (ratio of total trade in goods and services to GDP, in %)



Sources: WIIW (1997; 2000; 2003).

Before the transition process started, the transition countries were relatively closed economies except for the trade flows that existed among them. This was a consequence of the restrictions imposed by central planning, and of the planners' aspirations to insulate the country from influences of the world economy. All those countries had complicated regulations concerning foreign trade, foreign currency transactions and capital account controls, so it is not surprising that many studies find them to be less involved in international trade than the countries of Western Europe (see, for example, Havrylyshyn and Pritchett, 1991; Baldwin, 1994; Winters and Wang, 1994). Restrictive regulation

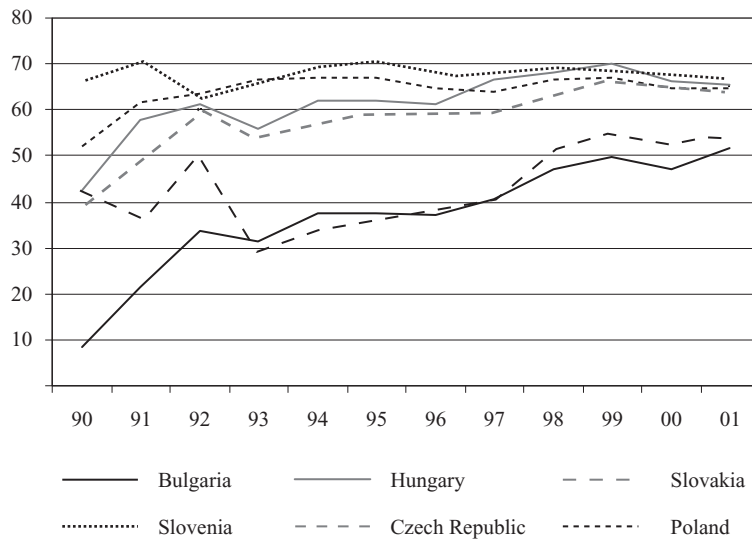
was radically liberalized very early, at the beginning of the transition, which encouraged the expansion of foreign trade. Indeed, trade openness ratios (TOR – ratio of foreign trade in goods to GDP) of the CEEC were clearly rising during the 1990s. The average TOR of the six selected countries more than doubled by the end of the decade from the level of below 50% in 1990. Moreover, studies confirmed that the increase of trade openness was related to progress in structural reforms, so countries that conducted deeper and faster reforms (measured by transition index, EBRD, 2004) also experienced larger increases in their trade openness (Havrylyshyn and Al-Atrash, 1998).

In conjunction with experiencing an increase in their trade openness, transition countries also changed the geographic patterns of their foreign trade. Such a change was a consequence of the collapse of COMECON, which diverted their foreign trade towards other members of that trade bloc. Havrylyshyn and Pritchett (1991), on the basis of gravity analysis, conclude that the CEEC did not need to raise the level of their overall trade, but they had to increase the share of trade with Western European countries from the level of between 20% and 30%, where it stood at the beginning of the 1980's, to the level of between 60% and 80% in order to adjust their actual trade to trade potentials. Using the gravity approach again, Winters and Wang (1994) draw a somewhat different conclusion for the mid-1980s. Although intra-COMECON trade, according to their estimates, broadly matched the potential, trade with market economies was by and large below potential. Hungary appeared to be the most open of the CEEC, with actual trade with market economies reaching less than a third of the potential. Another influential study by Baldwin (1994) on the trade potentials of the CEEC is especially interesting for our purposes because it provides estimates of the Croatian potential trade structure. Baldwin (1994) estimated the potential exports of the CEEC to the twelve EU members in 1989 (the last pre-transition year) to be 4.8 times higher than actual exports, while potential imports were estimated at 2.1 times the actual imports. Simultaneously, actual trade with other members of the Eastern bloc was between 0.4 times and 1.6 times higher than the trade potentials. According to these estimates, the twelve EU members should in the long run attract as much as approximately 60% of Croatian exports. With exports to EFTA-6 included, this share increases to 76%.

Even though different studies arrive at different quantitative conclusions on the potential levels of trade openness and trade diver-

sion with respect to intra-CEEC trade, depending on the estimates of GDP and trade, which could not be valued according to market prices before the transition, they coincide on the large potential that exists for an increase in trade with Western European countries compared with the level prevailing before the collapse of COMECON. The share of the fifteen EU member countries in selected CEEC's trade indeed rose from about 42% (being already considerably higher than their share in the early 1980s) to 61% of their total trade during the 1990s. Slovenia and Slovakia are seemingly exceptions from such dynamics with volatile trade behavior during the early 1990s. In the case of those countries stagnation and slow growth of the EU share in their total trade during the 1990s resulted from the dissolution of multi-national states and the conversion of trade with the former members of the federations to international trade, which reduced the share of EU members in total trade. If the effect of the dissolution is excluded, the dynamics of their geographical trade pattern do not substantially diverge from the dynamics observed in other countries.

Figure 2 Share of the EU-15 in Central and Eastern European countries merchandise trade (in %)



Sources: WIIW (1997; 2000; 2003).



In addition to the above-mentioned factors, GDP growth also affected the dynamics of international trade. Countries that grew faster during the 1990s ended up trading more both in volume and as a proportion of GDP. GDP dynamics were also influenced by success in the implementation of structural reforms, so it was an additional reason for successful countries increasing their trade openness and trade integration, while less successful countries had lower trade shares and volumes on average.

During the second half of the 1990s, EU members' share in CEEC trade grew somewhat slower, although CEEC trade openness continued to grow. Nilsson (1999) reported that by 1995 the CEEC's geographic trade pattern matched the trade structure of a typical developed country or OECD member. Brenton and Di Mauro (1998) reached a similar conclusion from a more detailed analysis of trade flows according to individual sectors, especially trade in sensitive products such as apparel or agricultural products. As low-wage countries usually enjoy comparative advantages in the production of labor-intensive products, the EU retained trade barriers for the imports of those products from the CEEC until the end of the 1990s. However, even trade in sensitive products between the EU and the CEEC, regardless of the existing tariffs and quotas, reached its potential by 1999. Therefore, Brenton and Di Mauro did not expect it to grow further. Di Mauro (2000) even proclaims the end of trade integration between the EU and the CEEC and announces "deeper" integration characterized by stronger foreign direct investment (FDI) flows.

The studies discussed are interesting since they indicate that the CEEC were highly integrated with the EU by the mid-1990s, as far as trade is concerned. However, the Commission's evaluation of their economic readiness was not as enthusiastic. The Commission did not acknowledge five of the candidate countries from central and east Europe (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) and all three Baltic countries (Estonia, Latvia and Lithuania) as functioning market economies until 2000, when the Commission published its third report on the progress made towards accession by the candidate countries. However, even at that time all those candidates, according to the Commission, needed to pursue further reforms in order to be able to cope with competitive pressures and market forces within the Union in the medium term and none of those countries came any closer towards fulfillment of the second economic criterion until 2002, or the last time they were included in the Commission's report. Bulgaria was recognized as a functioning market

economy in the report for 2002, while Romania was the last to be acknowledged, in the report for 2003.

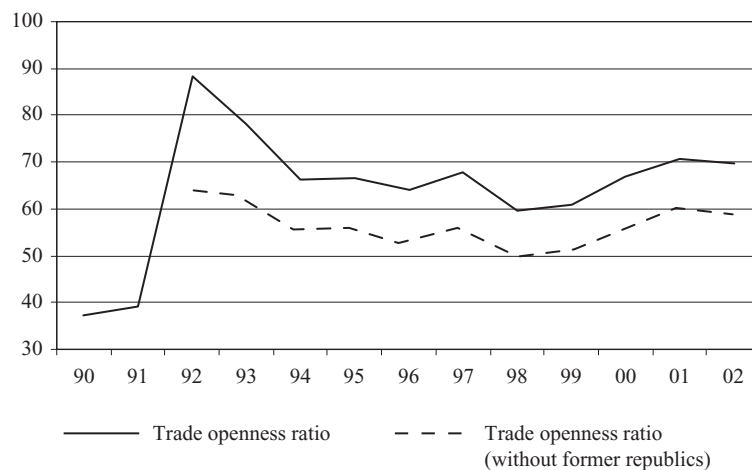
## **CROATIAN TRADE INTEGRATION INTO THE EUROPEAN UNION**

The Commission in its Opinion on the application of Croatia for membership of the EU evaluated the same lengthy array of different indicators of economic development, macroeconomic environment and implemented structural reforms, which is supposed to show progress in eleven areas of the Commission's interest, as had been the case in the previous applications. In its Opinion the Commission recognized Croatia as a functioning market economy. However, the Commission considered Croatia to be unable to cope with competitive pressures and market forces within the Union, although Croatia should be able to satisfy the second criterion provided that it continued implementing its reforms to remove the remaining weaknesses.

Indicators of trade liberalization and trade openness constitute one of the groups that the Commission evaluated within the second criterion, in which Croatia scored rather favorably. Having in mind the importance of trade for the Commission and even more for some researchers, it seems justified to explore trade integration between the Croatia and the EU in more detail. At the time of the declaration of independence, with TOR being as high as 90%<sup>vi</sup>, Croatia was a very open economy. However, while other CEEC became more open as the transition advanced, Croatia became less open and the TOR continued falling until the mid-1990s. The TOR decrease was not reversed until the late 1990s and the period of more intense trade liberalization, when it reached about 70%. TOR decline during the first couple of years after independence was mostly due to reduced trade with former Yugoslav republics, while trade with other countries stagnated, measured as a proportion of GDP. Moreover, Croatian TOR was below the range of 90-130% where the CEEC's TOR stood at the end of the 1990s, with the exception of Poland, which is a large and therefore less open country. As trade openness is influenced by geographic location, transport infrastructure, border regimes and a number of other factors that are hard to quantify, it is difficult to state unambiguously whether Croatia was a less open country in terms of foreign trade than the CEEC.

Obviously, trade in services, especially tourism, is particularly important for Croatia, which increases its openness.

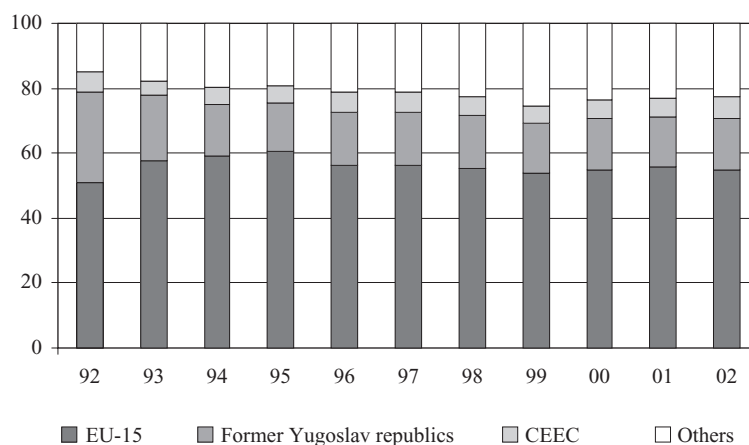
Figure 3 Croatian trade openness ratio (in %)



Source: CBS

The extent of trade distortions existing in Croatia at the beginning of the transition, according to some of the quoted studies, was below that of other transition countries. However, although the former Yugoslavia was not a member of COMECON, the collapse of the latter amid the fall of the Iron Curtain led to a diversion of excess trade with that block. Havrylyshyn and Pritchett (1991) suggest, based on an estimated gravity equation, that Yugoslavian trade with the CEEC exceeded the “natural” volume by 13 percentage points of the trade total at the beginning of the 1980s, while, at the same time, trade with Northern Europe fell short of “natural” trade levels by 18 percentage points. This is a fairly small trade bias compared with the degree of trade reorientation needed in other CEEC, some of which, according to estimates made by Havrylyshyn and Pritchett, needed to reorient almost three-quarters of their trade. However, Croatia suffered from another type of bias – the regulations of international trade encouraged trade with the former Yugoslav republics. The data from the 1987 input-output tables reveal that Croatian trade with the former Yugoslav republics was more than two times larger than overall foreign trade.

Figure 4 Geographical structure of Croatian foreign trade



Source: CBS

Croatian trade had been partially diversified prior to the break-up of the former Yugoslavia, so by 1992 the share of the former Yugoslav republics fell to less than a third of total trade. Diversification of imports towards the other countries was particularly fast as imports quickly rose after a slump caused by the break-up, while the rise in exports was much less vigorous. The process of trade diversification continued until the mid-1990s when the share of the former Yugoslav republics reached about 15% of total trade. Since then, the proportion taken by the former Yugoslav republics in Croatian trade has stagnated and even recovered somewhat. Increase in the proportion taken by the EU was the other side of the diversification process. Before the break-up of the former Yugoslavia, EU members accounted for about 60% of Croatian trade, and after the rise in bilateral trade, the share of EU members rose as well and then stabilized in the first half of the 1990s at between 50% and 60% of the total. Such a dynamic corresponds to a slight increase in the share of EU members compared to the beginning of the 1990s due to the break-up. If trade with former Yugoslav republics is excluded from the total, the share of EU members reaches 65% of the rest.

There are no rigorous estimates on the size of the home-country bias in the former Yugoslavia. However, Fidrmuc and Fidrmuc (2000) find that the level of trade between Slovenia and Croatia in 1990, prior to the break-up, exceeded the “normal” level 24 times. This figure is

rather high in comparison with the above-mentioned estimates of home-country biases prevailing in high-income countries<sup>vii</sup>, but low in comparison with other transition countries. For example, according to the same study, trade flows among the three groups of newly independent (successor) countries – the Czech Republic and Slovakia; the three Baltic States; and the Belarus-Russia-Ukraine area – exceeded “normal trade” by 41-43 times. In accordance with the falling trade between the Croatia and the former Yugoslav republics, Fidrmuc and Fidrmuc (2000) report that by 1998 the level of trade between Croatia and Slovenia exceeded the “normal” level only two times, between the Czech and the Slovak Republics seven times, 13 times among the Baltic States and 30 times among Belarus, Russia and Ukraine.

The geographical pattern of Croatian trade does not reveal whether Croatia has completed the transition in trade. Stabilization of the geographical trade pattern along with a fairly high proportion taken by EU members in total trade might suggest that Croatian trade converged towards its potential. However, the stagnation of the Croatian TOR somewhat below the TORs of other CEEC indicates the possibility of an interruption in trade transition. In order to shed more light on that issue, a gravity model will be used to estimate the remaining biases in the Croatian trade with the EU members, the CEEC and the former Yugoslav republics. The gravity model was estimated for three different time periods: 1999, 2002 and 2003. The first of those years is interesting because it precedes Croatian WTO membership (Croatia became a WTO member in 2000) and many other trade integrations (in 1999 Croatia had preferential trade agreements with Slovenia, Macedonia and Bosnia and Herzegovina<sup>viii</sup>, while by 2003 the number of preferential trade agreements had increased to 31, including all of the old and new EU members<sup>ix</sup> along with the Norway, Switzerland, Lichtenstein, Iceland and Turkey) so the gravity model will also estimate first effects of trade agreements. As the Stabilization and Association Agreement (SAA) is qualitatively different from the Europe Agreements concluded between the EU and the CEEC at the beginning of the 1990s, the future effects of the SAA will probably differ from the experience of the CEEC. On the one hand, Croatia managed to reach a more favorable position than the CEEC since most of the previous barriers to exports of sensitive products are absent from the SAA. However, the Croatian SAA also has an important drawback compared to the Europe Agreements since Croatia was not admitted into the Pan-European Diagonal Cumulation of Origin, which is men-

tioned as a serious obstacle to future expansion of trade even by the European Commission (Brenton and Di Mauro, 1998; European Commission, 2004; Mayhew, 1998). Discussion about the inclusion of EU candidate countries into the system was vigorously debated at the beginning of the 1990s. Baldwin (1994) particularly supported their inclusion because he judged that leaving the candidates out of the system would significantly weaken FDI inflows, which proved to be the crucial prerequisite for successful trade integration.

Ordinary least squares were used in order to estimate nine gravity models (encompassing exports, imports and total trade for all three of the selected periods). The coefficient of determination in the estimated models falls within the acceptable range for gravity models (between 0.56 for exports in 1999 and 0.82 for total trade in 2003), with a growing tendency towards the end of the observed time span. Due to the heterogeneity of the countries included in the model, estimated model exhibit heteroscedasticity in residuals, which is often the case in gravity literature, so standard errors were estimated using the Newey-West procedure. Some of the estimated dummy variables are not significant in individual or even all of the periods estimated, but they are nevertheless kept in the model because the goal of the estimated models was to determine whether the actual Croatian trade flows diverge from the potentials. Moreover, all the dummy variables were kept through all of the periods in order to maintain the same structure in the model.

The gravity model reveals that total Croatian trade with the old EU members did not significantly differ from the trade potentials throughout the entire observed period. The actual level of imports was estimated to be somewhat above the potential, while actual exports were somewhat below the potential, although the dummy variables denoting the trade flows with the old EU members were found to be insignificant, which might arise from differing levels of integration with different member states, so the level of the estimated parameter could be interpreted as an indication of averaged different trade flows. Actual trade with the CEEC exhibited a rising tendency with respect to trade potentials so it exceeded the potential trade by 112% in 2003, arising from high and rising imports compared to their potential. Trade with the old EU members exhibited similar dynamics. All of the trade potentials were estimated on the basis of Croatian trade with the rest of the world, comprising between a quarter and a fifth of total trade during the observed time span, so trade potentials with the CEEC, old EU members and former Yugoslav republics will be underestimated to the extent that

there is unfulfilled trade potential with the rest of the world. Construction of a gravity model for a larger group of developed countries, such as OECD members, and using it in order to estimate Croatian trade potentials could partially solve this problem. However, in that case the constructed model would exhibit the average propensity to trade of those countries, which could differ from the Croatian propensity.

*Table 1 Difference between the actual and potential Croatian trade (in %)*

	EU-15	CEEC	Bosnia & Herzegovina	Slovenia	Macedonia	Serbia & Montenegro
<b>Exports</b>						
1999	-27.4*	-39.8*	5,713.9	410.5	2,132.2	62.8*
2002	-19.5*	-36.4*	4,074.9	183.3	1,146.1	608.6
2003	-53.2*	-57.4*	2,647.6	-1.7*	1,055.9	286.9
<b>Imports</b>						
1999	61.7*	260.7	4,680.6	2,744.9	5,074.8	243.4
2002	54.6*	286.2	3,818.8	2,197.7	3,998.0	419.0
2003	85.5*	547.8	5,372.1	3,296.9	4,329.9	671.4
<b>Total trade</b>						
1999	-10.3*	32.6	6,096.5	791.9	3,171.5	86.9*
2002	-15.0*	47.4	4,854.4	522.4	2,311.1	488.9
2003	-10.6*	112.0	5,734.1	626.1	2,536.7	546.2

\* not statistically significant (at the 10% level)

Source: authors' calculations

Regardless of the stated deficiencies, it is interesting to examine the extent and persistence of biases that exist in trade with the former Yugoslav republics. The largest bias, amongst the most recent observations, can be observed in trade with Bosnia and Herzegovina, which exceeded the potential by about 5,700%. The decrease and subsequent increase of this bias can probably be traced to the abolishment and renewal of the preferential trade agreement. High bias was also found in trade with Macedonia, but it was reduced in recent years, which is consistent with the conclusion of new trade agreements and diversification of trade. Increase of trade with Serbia and Montenegro also increased the bias, but it preceded conclusion of the preferential trade agreement that came into force in 2003. Bias in trade with Slovenia was high throughout the observed time-span, notwithstanding some minor fluctuations, although bias in exports was decreasing and bias in imports was growing.

Significant reduction of some estimated biases in exports during the observed time span does not arise from the reduction of exports to

the old EU members, CEEC and some of the former Yugoslav republics, but rather from growing exports to the rest of the world. In line with this notion, high estimated biases in Croatian trade with the former Yugoslav republics do not necessarily mean that Croatia is trading to that extent above the true “potential”, for it might also signal insufficient trade with other countries. Such a conclusion is supported by Fidrmuc and Fidrmuc (2000) who find that the level of trade between Croatia and Slovenia exceeded the “potential” only two times in 1998, based on the estimated trade propensity of the OECD countries. Additional indicative confirmation is provided by Fidrmuc (2004) who included Croatia in a large-scale gravity model estimated for a total of 60 countries. On the basis of aggregation of estimated country-specific fixed effects, Fidrmuc concludes that Croatia belongs to a group of countries with significant unfulfilled trade potentials (Croatia is positioned 51<sup>st</sup> amongst the 60 countries, with the level of trade integration with the world similar to Malta and somewhat higher than Lithuania, Latvia, Belarus, Macedonia, Moldova, Bosnia and Herzegovina and Albania, which are positioned at the back, while all of the CEEC, according to this indicator, were better integrated into world trade than Croatia). It should be kept in mind that aggregation of fixed effects also reflects a number of other country-specific factors, although the rankings suggests that Croatia belongs to the group of countries that are relatively poorly integrated into the world trade. Another possible way to assess the level of trade integration with the world is to include internal trade into the gravity model (McCallum, 1995; Wei, 1996). However, such an approach often relies on a number of crucial assumptions with respect to the way the model is constructed or on detailed statistical data on trade of individual territorial units within the observed country (the same level of data aggregation is preferable for trading partners as well), which is rarely available.

Even if all remnants of home-country biases between the Croatia and the former Yugoslav republics disappear, common border and language similarities will still encourage bilateral trade. Fidrmuc and Fidrmuc (2000) explicitly account for the impact of the common border that, according to their findings, increases the potential trade by about half. Therefore, accounting for the border effects would reduce the difference between the findings of this paper and the results of Fidrmuc and Fidrmuc (2000). Taking into the account their findings of the border effect on trade would reduce the estimated bias in bilateral trade between Croatia and the neighboring former Yugoslav republics by about a third.



Regardless of the transformation of the Croatian trade pattern, the estimated gravity model suggests that home-country bias in trade with former Yugoslav republics remains significant. Moreover, the conclusion of numerous preferential trade agreements initiated the restoration of the old trade patterns and strengthened the trade links with the former Yugoslav republics, working against further trade diversification. The considerable Croatian delay in trade integration with the old EU members and the CEEC seems to be related to the high and even rising biases in trade with the former Yugoslav republics. Brenton and Di Mauro (1998) conclude that liberalized access to some of the CEEC on the EU's internal market might result in the crowding out of the other CEEC since they are direct competitors. Such a view is opposite to the previous fears in some of the old EU members, especially the southern countries (Portugal, Spain, Italy and Greece), of competition from the CEEC, which generally proved to be unfounded. A change in the attitude of the European Commission is especially visible in the willingness to grant more favorable access to the EU market with respect to sensitive products than was previously the case with the new members. So far, only Croatia and Macedonia have managed to conclude preferential trade agreements in order to exploit this change in the Commission's attitude.

The Croatian economy, which lost ground on the EU market due to delays in integration processes, is still making use of its favorable access to the markets of former Yugoslav republics. Such a position provides only a temporary shelter, until those countries open up and provide Croatian competitors an equal access to their markets. Design of the "right" trade regime for Croatia would therefore reduce existing biases in international trade and increase the long-term potential for growth.

## CONCLUSIONS AND RECOMMENDATIONS

The European Commission, as early as the first Opinion, rather favorably assessed the Croatian ability to pursue further economic integration into the EU. New EU members did not earn comparable assessment until 2000 (that is four years prior to the accession). Notwithstanding the Commission's assessment, the pattern and dynamics of Croatian trade still exhibit a strong bias towards the former Yugoslav republics, Bosnia and Herzegovina and Macedonia in particular, although there is a stable bias towards Slovenia and a growing bias

towards Serbia and Montenegro. Those biases evolved from inherited trade patterns that were supported by the early conclusion of preferential trade agreements with some of those countries. The gravity analysis performed does not clearly suggest any remaining trade potential with the EU member states, which might result from the properties of the gravity model as well as from differences in trade relations with individual EU members. However, stagnation of the trade openness ratio at a somewhat lower level than in the case of the other CEEC's, as well as findings from some recent research (Fidrmuc, 2004), suggest precisely that.

Such a position with respect to trade integration can probably best be explained by loss of ground in the market of the EU on account of the competitors from the group of the CEEC that advanced faster in trade integration. The lost ground cannot be recovered in the short run, but trade integration with the EU should be accelerated in order to reduce the existing biases and the long-term costs of trade restructuring. This primarily pertains to the Pan-European Diagonal Cumulation of Origin, to which Croatia is still not admitted. The CEEC, probably Croatia's most serious competitors on that market, are at the same time full EU members after about a decade of participation in the Pan-European Diagonal Cumulation of Origin. The existing system of bilateral trade relations actually means that a large portion of trade between Croatia and the EU is not carried out within a free trade regime, which inhibits manufacturing FDI and hinders Croatian integration into European production chains. Since a high level of trade integration has been considered in this paper not only as a precondition for successful economic integration but also as a consequence of the efficient removal of institutional barriers to trade, in order to facilitate trade integration with EU members it would be desirable for Croatia to join the EU as quickly as possible. On the other hand, efforts to integrate more deeply with countries of South-East Europe would only provide a temporary shelter on markets of countries that are even less open than the Croatian market. This strategy would increase the long-term costs of trade restructuring so it should in no case be a policy priority.

Finally, in order to resolve the existing trade biases, it would be more important to increase trade with countries where there is no excess above the "potential" (especially EU members as well as other countries that are not particularly emphasized in the analysis) than to decrease trade with the former Yugoslav republics and with some of the CEEC. Increased trade with those countries would also raise the level

of trade openness, in which Croatia also lags behind. Empirical evidence that points to the link between structural reforms and trade openness suggests that fostering those reforms would be the correct way to increase trade openness. According to the EBRD transition index, Croatia, despite some recent improvements, still lags behind seven of the new EU members<sup>x</sup> in conduct of the reforms (EBRD, 2004). Fostering reforms such as privatization, strengthening the rule of law and reduction of the role of the state in the economy are therefore necessary to increase trade integration as well as competitiveness, both being preconditions for successful accession to the EU.

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- i *The Europe agreements arranged between the transition countries that became EU members in 2004 and the EU are the first generation of Association agreements designed for the transition countries. Those agreements were concluded between 1993 and 1996, while they came into force in 1994 (Hungary and Poland), 1995 (Czech and Slovak Republics), 1998 (the three Baltic Republics) and 1999 (Slovenia).*
  - ii *Surplus on the services account of the balance of payments compensates to a large extent for the exceptionally high Croatian trade deficit. Unfortunately, it is not possible to include trade in services into the gravity analysis because there are no data on the geographic pattern on trade in services, although it would be more than justified in the case of Croatia. Analysis of the current account deficit, or comparison of the actual current account deficit with the expected deficit on the basis of GDP level and GDP growth (or demand for foreign savings), access to the international financial markets (supply of foreign capital), would therefore be a more comprehensive approach to the analysis of the trade deficit. Economic integration can fuel capital inflows, increasing the current account deficit and seemingly leading to a deterioration in competitiveness, while higher foreign investments at the same time foster productivity growth (Blanchard and Giavazzi, 2002).*
  - iii *Usually only imports are included into gravity models because it is assumed that their statistical coverage is better, due to the collection of customs. Since a single country gravity model is utilized in this paper, imports and exports will be treated separately, as well as total trade, or the sum of imports and exports.*
  - iv *In this paper Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia are considered CEEC. Those countries used to belong to the Council for Mutual Economic Assistance (COMECON), while today they are EU candidates or member states.*
  - v *Although it is undisputable that borders reduce trade, there are different explanations how and why this happens. While some researchers consider the home-country bias in trade to be mostly a result of tariffs and endogenous historical developments, such as the development of the transport network and other infrastructure (Djankov and Freund, 2000), other researchers emphasize the role that a common currency has in promoting trade (Rose, 2000), while others again point to the increase in the costs of acquiring information when business is done across the borders (see, for example, Obstfeld and Rogoff, 2000).*
  - vi *The jump of TOR after the proclamation of independence in part arises from the reduction of foreign currency value of non-tradables due to hyperinflation and in*

- part also from the conversion of trade with former Yugoslav republics to international trade (the difference between the full and the dotted line in the figure).*
- vii *For example, Helliwell (1998) found that during the period 1993-96 the Canadian provinces traded 12 times more among themselves than with US federal states, accounting for the differences in incomes and distance.*
  - viii *Croatia concluded the first preferential trade agreement with Bosnia and Herzegovina. However, the agreement was abolished in 1998 due to IMF demands for Bosnia to increase custom revenues, but it was restored in January 2001 on an asymmetrical basis. A preferential trade agreement with Slovenia has been in force since January 1998 and with Macedonia from October 1997.*
  - ix *Including Luxembourg.*
  - x *Slovenia is the eighth country from that group and the only country with a somewhat weaker transition index than Croatia.*

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## Chapter 4

# FREEDOM OF MOVEMENT OF WORKERS IN THE ENLARGED EUROPEAN UNION AND ITS EFFECT ON CROATIA

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## ABSTRACT

This paper deals with the free movement of workers in the context of EU enlargement with specific focus on the transitional period. The purpose of the paper is to present two main challenges Croatia will face in the accession negotiations of the chapter on free movement of workers: harmonization of legislation and a transitional period for the movement of its workers after the accession. With regard to legal harmonization, the paper gives an overview of the EU rules and Croatian legislation dealing with the free movement of workers. In order to explain the effect of the movement of workers in the enlarged EU on Croatia, it is necessary to look at the trends of labour migration in the EU and Croatia. The other important issue is the transitional arrangement agreed with the new EU member states, for a similar arrangement might be proposed to Croatia during accession negotiations.

### **Key words:**

employment, enlargement, European Union, labour mobility, migration, negotiations, transitional period

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## INTRODUCTION

The free movement of workers is one of the founding principles of the EU that constitutes one of the four fundamental freedoms of the Internal Market. At the same time, it represents one of the most important rights of individuals under Community law. Freedom of movement of workers is usually interconnected with several issues: the right to move and reside freely when working in another member state, social security rights, mutual recognition of qualifications, civic rights and European citizenship. Croatia as a candidate country will soon start negotiations for membership in the EU. Under Chapter II of the negotiations, on freedom of movement of persons, the free movement of workers is included.

The purpose of this paper is to present two main challenges that Croatia will face during the negotiations of this chapter: harmonization of its legislation and the EU request for a transitional period regarding the movement of Croatian workers after the accession. This paper deals with the free movement of workers in the context of EU enlargement with specific emphasis on the transitional period. In the first part, the text gives a brief overview of the EU legislative context for the free movement of workers, which enshrines the principle of the free movement of labour in the EU. The second part deals with the level of labour migration between new and old EU member states<sup>1</sup>, looking at mobility of workers in some of them. Countries used as examples include Slovenia, Austria and Hungary. The choice of the countries was made because of their geographical closeness to Croatia and also because of their enlargement experience. The third part of this text focuses on the transitional period as an inevitable request for the workers from new member states (NMS). Since Croatia will almost certainly be asked to accept a transitional period for its workers as well, this chapter presents the transitional arrangements in the case of the last EU enlargement and explains what is meant in practical terms. The state of the negotiations with Bulgaria and Romania on the free movement of workers is considered because of their future accession to the EU, possibly at the same time as Croatia. Part four addresses the current situation in Croatia focusing on the legal framework, current employment trends and the mobility of Croatian workers. At the end, the text explains the effect of the transitional arrangements of the NMS on Croatia and offers some recommendations.

## REGULATION AND REQUIREMENTS FOR THE FREE MOVEMENT OF WORKERS IN THE EUROPEAN UNION

### Legislative framework

The free movement of workers in the EU is regulated by the provisions of the Treaty establishing the European Community, Articles 39-42/Title III Free Movement of Persons, Services and Capital<sup>ii</sup>. These principles embody the principle of non-discrimination on grounds of nationality among workers of the member states with regard to hiring, remuneration and other conditions of employment. Furthermore, the free movement of workers is regulated by secondary legislation, including a number of directives and regulations. Directives and regulations that provide for the freedom of movement for workers and their families within the Community are particularly important for the practical application of this freedom.<sup>iii</sup> The case law of the Court of Justice of the European Communities (ECJ) is another important source of rules on the free movement of workers. By virtue of its judgements and broad interpretations of the provisions regulating the freedom of movement of workers, ECJ has contributed substantially to the development of this part of the EU law.<sup>iv</sup> The Europe Agreements, which regulated the relations between candidate countries and the EU, should be mentioned as an important legal basis for NMS. The equivalent in Croatia is the Stabilisation and Association Agreement (SAA).

According to Community rules contained in the legal documents described above, a worker who moves to another member state has certain rights. These rights include in particular:

- right to work without a work permit (except for the workers from NMS covered by transitional period);
- equality of treatment in employment compared to nationals of the member state in which the work is carried out;
- entitlement to the same social benefits as nationals;
- the right of the family to join the worker and to receive family allowances;
- full coordination of social security (pension rights and social security contributions);
- mutual recognition of professional and vocational qualifications.

This broad selection of rights offered to the nationals of member states confirms the importance of the free movement of workers as one of the fundamental rights of the EU. It also aims to facilitate the labour mobility between the EU member states as an important tool for the realization of the internal market.

### **Reality of the labour movement in the European Union**

The EU labour force is characterized by a low level of geographical and occupational mobility. In the period between 1991 and 2001 only 15% of EU citizens changed their place of residence for the purpose of working in another member state (European Commission, 2004a). Employment in another member state as a reason for migration was present mostly in the southern EU countries – Italy (61%), Portugal (46%) and Spain (30%). In 2001, the UK and Sweden had the highest percentage of labour mobility (around 2%) while workers from Greece and Spain showed total immobility<sup>v</sup>. Nowadays, only 2% of the working-age population of the EU are working in another member state. The guaranteed full freedom of movement of EU workers and professionals has thus not been completely effectuated. EU citizens still face obstacles of a legal, practical or administrative nature when planning to settle in another EU member state. The low level of labour mobility among member states has been identified as one of these obstacles. The other obstacles include long administrative procedures, incomplete implementation of rules, lack of necessary information about the rights of workers moving to another member state, insufficient co-operation between member states, and a low level of participation in the life-long learning process. The low level of labour migration in the EU has negative consequences on economic growth, employment and the occupational skills of the labour force. Aware of this problem, the EU has been trying to remove these obstacles by different measures, in order to improve the employment situation and encourage labour mobility. The creation of the Commission's Action Plan for Skills and Mobility (European Commission, 2002a) followed by the Report on its Implementation (European Commission, 2004a) and the establishment of the European Job Mobility Information Portal are just some of these measures.<sup>vi</sup> Old EU member states also undertook several national

measures to improve geographical labour mobility such as sectoral recruitment activities (Austria), specific mobility assistance for unemployed workers (Germany and Sweden), promotion of mobility inside the public administration (Denmark and Portugal).

There is a shortage of necessary professionals in some old member states, due to undeveloped labour migration. Therefore, in order to create a competitive European labour market, labour mobility should be improved, in which professionals and workers from NMS can help. The same could be concluded in relation to unemployment. The average unemployment rate in the old member states (taking into account the differences among them) amounts to 9%, which is higher than the unemployment in some new EU member states – the Czech Republic, 7.8%; Hungary, 5.9% and Slovenia, 6.8% (ILO, 2003). Accordingly, the positive aspects of labour migration in the EU should include a lower EU unemployment rate and a further boost to the economy and competitiveness of the Internal Market. Consequently, the EU needs a more mobile workforce in order to balance its labour market and achieve full freedom of movement, especially after the enlargement. It will bring about greater diversity, create more jobs and higher employment, and it will have positive effect on the EU economy.

## **LABOUR MIGRATION BETWEEN OLD AND NEW MEMBER STATES**

### **Will accession cause migrations to old member states?**

The push factors that usually influence migration trends include: unemployment, lack of job opportunities and low income in the emigration country (Werner, 1994).

If we take a look at the transition countries, unemployment seemed to discourage overall migration, and economically less developed regions showed very low labour mobility (Fidermuc, 2001). Commonly, in a situation of high unemployment people fear migration as a force that will lead to even higher unemployment (Mayhew, 1998). Hence, mobility of migrant workers from NMS has been low, when considered in relation to the wage and unemployment differences with the old member states. Looking at the readiness to migrate between

new and old member states, it seems that some old member states (for instance, Portugal) used to show a much higher level of readiness to migrate than NMS. Geographical proximity plays another important role in migration. The examples of Germany and Austria as the main countries receiving immigrants from NMS clearly show this. In the year 2000, 80% of employees emigrating from Central and Eastern European Countries (CEEC) resided in Germany and Austria (Boeri and Brücker, 2000). The biggest migration potential comes from Poland (nearly half of the foreign workers from NMS), Romania (17%), the Czech Republic and Slovakia together (11%) and Bulgaria (9%). During the whole process of the accession to the EU, the number of persons from CEECs employed in the old member states was previously considerable but due to the economic progress made by these countries, it has declined over the years (from 850,000 during the 1990s to 250,000 at the beginning of 2000). Consequently, despite the wage and unemployment differences with the old member states, the forecast for workers from NMS likely to migrate remains below EU worst-case estimations. The existence of migration from NMS was never such as to suggest a serious impact on the employment and labour market of the old EU member states. Research and estimated figures suggest that EU accession will not bring a major disturbance into the labour markets of old member states. Apparently, the number of people with a firm intention of taking advantage of mobility after enlargement accounts for just 1% of the working-age population of the new member states. Expected migration amounts to the estimated potential annual flow from NMS of around 200,000 just after the accession, which will probably decline to 85,000 after 10 years. (Boeri and Brücker, 2000). Temporary labour migration in border regions (commuting and seasonal work) and in neighbouring countries will continue, due to a rise in temporary migration as opposed to the permanent migration<sup>vii</sup>. Another important point should be kept in mind: the possibility that a lot of workers and professionals from old member states might migrate to the NMS (it has already occurred in the cases of the Czech Republic and Poland) and affect their labour markets. Taking into account factors such as increases in salaries and foreign investment, better job opportunities, lower unemployment, language barriers and traditional strong ties with their home countries, it is evident that the EU accession will not bring major inflows of migrant workers from CEEC. On the contrary, the result could be that after the accession, old member states might benefit from the migration of highly skilled labour from NMS. Most of the potential migrant workers from NMS are younger,

highly skilled, educated professionals who bring benefits to the countries to which they have come to work. Hence, the NMS might experience the problem of a brain-drain effect and face the risk of losing their best young and highly-skilled labour.

### **The examples of Slovenia, Austria and Hungary**

Slovenia is recognized as one of the most prosperous NMS. The unemployment rate in Slovenia is 6.8% which is lower than in Germany 9.3% or Italy 8.7% (ILO, 2003). In the first part of 2004, there were around 780 thousand persons in employment (Statistical Office of Slovenia, 2004). From 2003, the shortage of Slovene workers caused an increased demand for foreign workers in services, construction and agriculture. Most of the seasonal work in agriculture was concentrated in the border regions with Croatia. The majority of foreign workers in Slovenia come from Bosnia and Herzegovina (19,000), Croatia (6,900) and Serbia and Montenegro (6,500). Only 779 persons from EU countries were registered as workers in Slovenia in 2003 (Employment Service of the Republic of Slovenia, 2003). Bearing in mind the demand for foreign workers in Slovenia and its entry into the EU, the number of workers (including from NMS) could increase. As for Slovene workers abroad, until the accession to the EU, the migration from Slovenia was quite low. Slovenes worked mostly in Germany on the basis of employment agreements, usually seasonal jobs or training schemes. The accession of Slovenia to the EU will allow and motivate Slovene citizens to accept jobs in other EU countries. This motivation could work for migration with new EU member states, while there are no limitations on the free movement of workers. However, the prospect of greater labour mobility for Slovene workers to the old EU member states remains low due to the transitional period and the obligation to obtain work permits.

The population of Hungary amounts to 10 million, with a total number of 3,900,000 employed persons and 245,000 unemployed in 2003 (Hungarian Statistical Office, 2003). The unemployment rate amounts to 5.9 % which is lower than the EU average of 9% (ILO, 2003). The estimated labour movement from Hungary to the EU after the accession remains low and it is mostly oriented to Austria. The migration potential from Hungary to Austria after the accession amounts to 4,000 workers per year. Low labour mobility in Hungary

and higher wages after the EU accession are the main reasons why the number of Hungarian workers in Austria will remain in balance with the demand for foreign workers on the Austrian labour market.

The unemployment rate in Austria of 7% (ILO, 2003) is accompanied by a demand for highly skilled labour. This has resulted in the further application of bilateral agreements on cross-border commuters and trainees for the period of six months. The intention is to enhance regional integration until free movement of labour is achieved completely. EU enlargement will not bring substantial changes especially because of the five year transitional period for the movement of workers. The Austrian Labour Office has estimated that there are fewer than 19,000 foreign workers working in Austria, coming from Slovenia (app. 6,000), the Czech Republic (app. 4,000), Hungary (app. 8,000) with many commuters from Slovakia (Foti, 2003). The number of possible migrant workers from CEEC to Austria after the EU enlargement would be around 23,000 to 45,000 a year.<sup>viii</sup>

## **TRANSITIONAL PERIOD FOR THE FREE MOVEMENT OF WORKERS**

Labour mobility is indispensable for the successful and efficient functioning of the EU Internal Market, for stimulating employment and for economic growth. Accordingly, the free movement of workers is a particularly sensitive issue for the EU, which usually imposes certain limitations on the free movement of workers from NMS. One of these limitations is expressed in the form of a transitional period. In the history of EU enlargements, there has commonly been a transitional period for the free movement of workers as the condition for NMS. For example, Greece had to accept a six year transitional period before its workers could be fully mobile within the EU. During that time workers from Greece had to possess work and residence permits, just like non-EU nationals. A similar transitional period of seven years applied to Spain and Portugal, and their workers did not have open access to employment, while the freedom of movement was achieved gradually. The history of the EU enlargement has shown that fears of a mass inflow of migrant workers from NMS is unfounded and that emigration tends to fall rather than rise after an enlargement. Despite this, the EU has continued require a transitional period (amounting usually to a peri-

od of 7 years) before the fully free movement of workers from NMS. The last EU enlargement is no exception to this rule and the NMS agreed to such a transitional period. Consequently, it is necessary to take into account the transitional period as one important factor that Croatia will encounter during the negotiations.

### **Transitional arrangements with new member states**

In the last accession, the EU requested a transitional period for the free movement of workers from all acceding countries except Cyprus and Malta.<sup>ix</sup> The main reason for this EU stipulation is the possibility of higher level of labour mobility and thus the disturbance of the labour markets of certain member states. Concern about a mass inflow of workers from NMS is based on factors such as geographical proximity, wage differentials and the level of unemployment in NMS. The biggest concern is actually linked to the fear that migrant workers from NMS will exhaust the resources of the benefits systems currently enjoyed by the nationals of old member states (Boeri, 2004).

Transitional arrangements have been agreed as follows:

- Two years after the accession, old member states will apply national measures with respect to NMS, the final goal being the provision of full access to their labour markets for NMS.
- After the expiration of two years, countries that introduced national measures should submit reviews and inform the European Commission whether they intend to continue applying national measures for next three years. This procedure is followed by a Report from the European Commission.
- After five years the transitional period is suppose to end, but it leaves the possibility of prolonging the transitional period for an additional two years for those member states whose labour markets are particularly affected.
- Safeguard clauses may be applied by the old member states until the expiration of the seventh year after the accession of NMS.<sup>x</sup>

Most of the old member states introduced the above explained restrictions. Austria and Germany announced that they planned to keep the restrictions on migration for seven years. They also introduced specific restrictions as a safeguard for the service sectors of their labour



markets because of the danger of considerable disturbances in those sectors. A two year limitation in which work will be possible only with a work permit will apply in France, Belgium, Spain, Italy and Greece. Portugal introduced a quota for workers from NMS and the Netherlands set the number of 22,000 workers per year, which cannot be exceeded during the first two years of the transitional period. Finland will apply a two-year restriction and issue work permits only if there are no Finnish workers available for a certain job. Denmark and Sweden will also apply two year restrictive measures with the possibility of prolonging them for three more years due to the concern about the impact of labour migration on their social systems. The only exceptions are Great Britain and Ireland, which opened their labour markets from the first day of the accession of NMS with some limitations regarding the welfare systems. The reason for this decision is that the labour markets of these countries would not be so overburdened by the workers from NMS. Both the UK and Ireland have high levels of employment and the UK has been identified as one of the EU countries that might suffer a significant deficit of skilled labour by 2010 (Eurostat LFS, 2003).

Therefore, the NMS will have the guarantee for the full realization of the freedom of movement of their workers in 2011, but some member states might completely open their labour markets earlier.

### **Transitional arrangements in practice**

In practical terms, a transitional period means that the obligation to obtain a work permit continues to apply to nationals from NMS even after accession to the EU. For instance, in Austria the employer has to apply for a restricted work permit for a national from a NMS and freedom of movement is confirmed by the Labour Market Service. A similar procedure exists in Germany and, according to the transitional arrangement, nationals of NMS can be employed in Germany only under national measures or under the conditions provided for in bilateral agreements. However, it should be emphasised that the transitional arrangement does not influence the rights of workers who are already legally resident in one of the old member states. Community rules on equal treatment in working conditions and social security system will apply to those workers. Accordingly, the restrictions specified above can only influence access to the labour market. This means that after a worker from the NMS is admitted to the labour market as an employee

or a job-seeker, there cannot be any discrimination between him and the workers who are nationals of the member state in question. On the other hand, there is complete freedom of labour movement between NMS without any transitional arrangements. No transitional period is requested for the mutual recognition of qualifications either, meaning that Community rules regulating mutual recognition apply from the accession.<sup>xi</sup>

### **Positive outcomes of the transitional arrangements**

Besides the limitations that an agreed transitional period imposes upon the NMS there are also some positive sides of the negotiated transitional arrangement. Positive outcomes are expressed in the Standstill Clause and Community Preference Rule. The Standstill Clause requires that the access to the labour markets of old member states cannot be more restrictive for workers who are nationals of the NMS than it was at the time of the signature of the Accession Treaty (16 April 2003).

The Community Preference Rule means that the employers from old member states are obliged to give priority to workers from NMS over non-EU nationals. Moreover, NMS have the possibility of applying equal restrictions against those old member states that introduced restrictions on their workers. New member states that decided to apply those restrictions are Hungary and Slovenia.

### **Transitional period for Bulgaria and Romania**

Accession negotiations with Bulgaria and Romania were initiated in 2000. At the moment, these accession countries are trying to close the remaining chapters in order to be able to join the EU in 2007. However, the progress has been slow in some areas and it remains to be seen whether they will succeed in reaching their goal by the time planned, or whether other candidate countries, like Croatia, will move ahead faster. Bulgaria, with 8 million citizens, and Romania, with 21 million, are among the larger candidate countries, compared to Croatia or to NMS like Malta or Slovenia. The unemployment rates in Bulgaria of 13% and of 7% in Romania (ILO, 2003) are still higher than in the NMS. Accordingly, Bulgaria and Romania are perceived as the coun-

tries with the largest migration potential after the last EU enlargement. In consequence, in accession negotiations of the chapter on free movement of workers, these two countries have agreed to a limited freedom of movement for their workers during the transitional period that will last for a minimum of two years and a maximum for seven years after accession to the EU. Both countries still need to align their national legislations with EU legislation regulating the free movement of workers in order to be able to implement them by the date of the accession. The main EU objection refers to the provision on mutual recognition of qualifications. For Bulgaria, the other necessary adjustment relates to the social and cultural integration of migrant workers and their families. In the case of Romania, the EU finds that provisions of Romanian laws still do not provide for legislation on the equal treatment of EU workers.<sup>xii</sup>

## **WHAT LESSONS COULD CROATIA LEARN FROM THE NEW MEMBER STATES?**

### **The legal framework in Croatia**

The relevant legal framework for the free movement of workers between Croatia and EU is contained in the provisions of the SAA and the relevant Croatian legislation. The SAA regulates the free movement of workers between Croatia and EU member states (Title V, Movement of workers, establishment, supply of services, capital, Chapter I, Movement of workers, Articles 45-47).<sup>xiii</sup> The provisions on free movement are established on the principle of equal treatment and non-discrimination on the grounds of nationality against Croatian citizens or against workers from EU member states respectively, who are legally employed on the territory of Croatia or on the territory of a certain EU member state. The prohibition of discrimination applies to working conditions, remuneration or dismissal from employment for both nationals from Croatia and from EU member states (Article 45). Article 47 of the SAA regulates social security systems for workers from Croatia and EU member states. Croatian laws regulating the social security system provide for equal rights for foreigners and nationals (except if differently provided by international agreement). This legal basis makes it easier to implement the SAA. Croatia concluded several bilateral agreements on social security with EU member states corresponding with the well established EU practice.

The Law on Foreigners (NN 109/03) regulates the question of employment, work, residence and movement of foreigners. This Law ensures easier procedures for foreigners to work in Croatia and provides for the implementation of obligations deriving from the SAA. According to this Law, foreigners need to have work permits and the Government determines the annual quotas for foreign workers. However, this annual quota does not include the workers and members of their families whose status is regulated by the provisions of the SAA (Article 87). This provision of the Law on foreigners clearly has the purpose of removing possible obstacles for the free movement of workers from the EU. Although this Law is a good example of the necessary alignment with the EU *acquis*, the European Commission indicated that further adjustments to Croatian legislation will be required. The proposed alignment includes the possibility for EU workers to have equal access to employment in Croatia without discrimination on the grounds of nationality, to work without a work permit and to be joined by family members who will also be allowed to work without a work permit.<sup>xiv</sup>

## **Labour mobility in Croatia**

### **How mobile are Croatian workers?**

The population of Croatia is approximately 4.4 million and at the end of 2003 there were around 1.4 million employed persons and 330,780 unemployed persons (CBS, 2004). According to the International Labour Organisation (ILO) methodology, the unemployment rate in Croatia is still higher than the EU average (14.3% in 2003 and 13.8% in the first half of 2004). The young working population is especially hard hit by unemployment; in Croatia, 18% of unemployed persons are young people. From the total number of 1.7 million active population of Croatia, 47,000 persons emigrated to other countries (CBS, 2004). If we compare this with Slovenia and Hungary, in Slovenia from a total population of 2 million only around 1,800 Slovenes emigrated in 2003 (Statistical Office of Slovenia, 2004). In the case of Hungary, internal migration significantly outweighed emigration and a smaller number of Hungarian workers emigrated (Foti, 2003). From this comparison we can conclude that the number of Croatian citizens working abroad is still much higher than the numbers

from Slovenia or Hungary. Nevertheless, even a high level of unemployment and other migration push factors do not create such a large mobility of Croatian workers. The majority of Croatian workers abroad concentrate on the EU countries that are geographically closer like Slovenia, Italy, Austria and Germany. At the end of 2003, around 6,900 Croatians worked in Slovenia, doing mostly seasonal work (Employment Service of Slovenia, 2003). The accession of Slovenia to the EU has some practical implications for Croatian workers employed in Slovenia. Due to the transitional arrangement Slovenia had to impose some limitations on workers from non-EU countries. Hence, quotas for non-EU workers have been introduced, producing only 17,000 work permits for 2004. Consequently, a smaller number of Croatian workers will be able to work in Slovenia as a new EU member state.

According to the agreed quota between Germany and Croatia, unemployed Croatian citizens have the opportunity to spend a fixed period of time working in Germany. In 2003, Germany concluded an agreement with Croatia allowing 500 Croatian workers who are doing temporary work in Germany access to professional training for three years. However, the number of Croatian workers who actually went to Germany was low. Out of the 500 places available in 2003 only 319 were filled by Croats. It seems that despite better salaries and job opportunities equal to those of German nationals, Croatian workers are not all that interested in temporary work in Germany. The insufficient knowledge of language might appear an obstacle in some cases, but in others, it seems that Croatian workers are less inclined to go to Germany. The result might be the possible reduction in the annual number of work permits until Croatia joins the EU.<sup>xv</sup>

### **Foreign workers in Croatia**

According to the number of work permits issued in 2004 there are more than 2,000 foreign workers in Croatia. In comparison with Slovenia, which had around 30,000 foreign workers, or Austria with 20,000, Croatia does not seem to employ very many foreigners. However, looking at the high level of unemployment in Croatia, one would expect the tendency to reduce even this number for the sake of employing domestic workers. Yet, the demand from employers for foreign workers specialised in certain professions continued to grow. The decision on the annual quota of work permits for foreign workers

amounted to almost 2,600 for newly employed foreign workers<sup>xvi</sup>. The largest number of work permits was issued for the shipbuilding sector (1,100) followed by construction (1,000), science and education (150), tourism (310) and the health sector (30). In 2003, Croatia authorized work permits for workers from 34 countries. The majority workers in Croatia come from Bosnia and Herzegovina where the unemployment rate is very high, reaching 40% (Central Bank of Bosnia and Herzegovina, 2004).<sup>xvii</sup> This results in the large movement of Bosnian workers towards Slovenia and Croatia. The rest of foreign workers in Croatia come from Serbia and Montenegro, Turkey, Macedonia, Slovenia and Austria. The number of requested and issued work permits also corresponds with the increased need for seasonal workers in Croatia (especially during the tourist season).

#### **Expected movement of Croatian workers after the last enlargement**

At the moment the emigration rate from Croatia is considerable and the interest for seasonal work in countries like Germany, Austria or Italy still exists. In 2002, through the intervention of the Croatian Employment Bureau, 7,700 Croatian citizens went abroad to work and the majority of workers went to Germany for seasonal work (CEB, 2004). However, there is a developing trend of a lower mobility directed towards EU member states. This can be best observed in the above explained situation with Germany when only 319 workers made use of the 500 opportunities for work. Moreover, the possibility for Croatian workers to work in some NMS could be reduced due to the transitional arrangements of NMS (as explained for Slovenia). On the other hand, the progress of Croatia in next few years before the accession to the EU could further lower the level of labour migration, as happened in other transition countries. The economic growth, lower unemployment and closer perspective of the EU accession might attract more labour migration to Croatia (mostly from the region but also from other countries). Therefore, along with further European integration, labour migration should be followed closely in order to prevent the negative effects of losing the best professionals (brain-drain effect) and becoming overburdened with low-skilled workers from other regions. In sum, the enlargement should not produce a larger movement of Croatian workers to EU member states.

## **The influence of transitional arrangements on Croatia**

Taking into account traditional mobility of Croatian workers in connection with certain EU member states and the previous enlargement scenarios, it is clear that the EU will ask for a transitional period in which the movement of workers will still be subject to restrictions. The transitional arrangements agreed with the new EU member states will influence negotiations with Croatia. It is to be expected that a transitional arrangement similar to those of the last enlargement will be offered to Croatia. Therefore, in negotiations of this chapter of the *acquis*, Croatia should use the example of the transitional arrangement from the Treaty on Accession of the CEEC. A transitional period for five years with a gradual increase of worker mobility can be a good starting point in negotiations. Since it might possibly join the EU along with Bulgaria and Romania in the next wave of enlargement in 2007, Croatia should continue closely to follow the state of the accession negotiations with these two countries. More importantly, Croatia should try to obtain the best possible transitional arrangement for its workers by negotiating the mentioned Standstill Clause, Community Preference Rule and equal restrictions. In practical terms, transitional arrangements with NMS could influence the mobility of Croatian workers by imposing certain restrictions on non-EU workers and by an increased volume of labour movements among NMS.

## **CONCLUSIONS**

The free movement of workers has a central meaning for the realization of the EU Internal Market from the economic and social point of view. Taking into account the significance and sensitivity of this area for the EU, Croatia should expect to encounter two main challenges during the accession negotiations: the request that it should completely harmonize its legislation, and requirement of a transitional period. The status of Croatia as a candidate country proves that integration is already taking place and that we are moving in the right direction. In the chapter on the free movement of workers, this concretely means that some of the necessary legal adjustments and practical measures have already been undertaken. However, only half of the work has been done.

As pointed out by the European Commission, further harmonization of the law is necessary. In this respect, Croatia should completely align its legislation with the EU *acquis* on the free movement of workers, focusing on the mutual recognition of qualifications and the removal of the remaining barriers, in order to achieve non-discrimination of EU workers. The Government should introduce measures to ensure effective implementation of the harmonized legislation in the form of national strategies, implementation plans involving all relevant state actors like ministries, state institutes, social partners, civil society, the judiciary and academia. In the knowledge-based and service-sector oriented EU economy it is necessary to have a competitive and mobile workforce. Hence, Croatia should stimulate further education and training in order to obtain more competitive highly skilled professionals with an improved position on the EU labour market. In this regard, it is necessary to mobilise the resources for education and training by the private sector (companies), by the public sector (government, ministries) and by using available pre-accession EU funds.

A request by the EU for a transitional period before the full free movement of workers is another challenge Croatia will face during accession negotiations. Since all the smaller and economically weaker countries that have joined the EU to date had to go through a transitional period for their workers, it is prudent to expect that Croatia will also have to accept one. Consequently, during the negotiations, a transitional arrangement similar to that of the last enlargement could be offered to Croatia. Therefore, before the beginning of the accession negotiations, the Government should prepare negotiating teams with experts who possess specific knowledge of this area, combined with the necessary negotiating skills. Accession negotiations give a perfect opportunity to negotiate the best possible transitional arrangement. During the accession negotiations, Croatia should try to negotiate such an arrangement using examples of the NMS showing how this is possible. The transitional arrangement agreed with the NMS could influence Croatia by affecting the actual movement of Croatian workers. Due to transitional arrangements, the movement between NMS might increase and in some countries it might cause a reduction of the number of workers from non-EU countries. On the other hand, further economic development and the progress of Croatia in accession negotiations will reduce the need for Croatian workers to migrate. In this sense, the transitional arrangements can influence Croatia only to a certain extent.



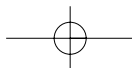
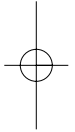
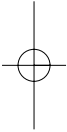
In order to enable active public participation in the whole process of negotiations and for widely-understood information about the requirements for working in a particular member state, the Government and the media should regularly inform the public about the state of negotiations of this chapter. Specific professions (lawyers, doctors, dentists, architects) have already expressed their interest in the influence of EU accession to the exercise of their professions. Taking this into account, the relevant state bodies, when preparing for the negotiations, should try to consult the professional associations and keep them informed about the rules that will apply to them.

From everything explained above, we can conclude that there will be benefits both for Croatia and for the EU in terms of creating more jobs and reducing the unemployment rates. It is true that there will be some limitations on workers from Croatia, due to the transitional arrangement that the EU will most probably request. However, it is also true that in the long run the anticipated benefits will prevail.

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- i *New member states include the countries that joined the EU on 1 May 2004 – the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia and Slovakia.*
  - ii *On 25 June 2004, the Intergovernmental Conference accepted the proposed Draft Treaty establishing a Constitution for Europe. The provisions on the Free Movement of Workers have been somewhat modified, so if the Treaty is accepted in all member states, these new provisions will apply.*
  - iii *For instance, Directive EEC 360/68, Regulation EEC 1612/68, Regulation 1251/70 and Directive EC 38/2004.*
  - iv *The most important cases in the ECJ include: Hoekstra v. Bestuur der Bedrijfsveereniging voor Detailhandel en Ambachten (1964), Levin v. Staatssecretaris van Justitie (1982), Lawrie-Blum vs. Land Baden-Württemberg (1986), Union Royale Belge des Societes de Football Association v. Bosman (1995), Rudy Grzelczyk v. Centre Public d'Aide Sociale d'Ottignies-Louvain-la-Neuve (CPAS), (2001), Craig de Burca (1998:678, 757-762).*
  - v *Report on the implementation of the Commission's Action Plan for Skills and Mobility, COM (2004) 66 Final, 37.*
  - vi *Other measures: Development of European Employment and Social Policy, creation of National Employment Action Plans, European Employment Strategy.*
  - vii *In Germany the number of temporary migrant workers reached 250,000 in 2000.*
  - viii *The biggest labour potential in Austria and Germany could be expected from Poland.*
  - ix *EU did not request a transitional period only in the case of the economically more prosperous new members like Austria and Sweden and in the last enlargement for Cyprus and Malta where the possibility of labour migration is very low.*
  - x *The safeguard clause means that the member states that initially opened their labour markets can latter introduce new restrictions with the authorisation of the European Commission if their labour markets are threatened or experience serious difficulties.*



- xi Although this text does not deal with mutual recognition of qualifications, it is important to note that Croatia will have to adjust its legislation with the EU rules on mutual recognition.*
- xii Regular Reports on Bulgaria's and Romania's Progress towards Accession to the EU, 2003.*
- xiii The procedure on ratification of the SAA finished on 13 December 2004 with the Council of Ministers decision on the conclusion of the SAA. It is expected that the SAA will enter into force on 1 February 2005 in accordance with the Article 129 of the SAA.*
- xiv The Opinion of the European Commission on the Application of Croatia for Membership of the European Union, April 2004.*
- xv This is also caused by the enlargement and the pressure of Hungarian, Polish and Slovene workers on Germany.*
- xvi Decision on the establishment of annual quota for the employment of foreign workers for the calendar year 2004 (NN 57/04).*
- xvii The data was used from the Central Bank of Bosnia and Herzegovina because there were no ILO statistics available. Consequently, the methodology used here is different and this data cannot be compared with the unemployment rates of other countries for which the ILO methodology was used.*



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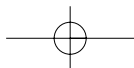
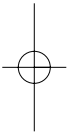
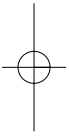
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## Chapter 5

# HOW PREPARED IS CROATIA FOR A KNOWLEDGE-BASED SOCIETY?

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Oh, yes, you have learned men. Who collect more facts than do the learned men of England. They collect facts, and facts, and empires of facts. But which of them will rekindle the light within?

*E. M. Forster: Howards End*

## ABSTRACT

Knowledge has become the key to economic competitiveness and success. An important part of an economy's overall competitiveness – the ability to achieve success on markets – is labour-force competitiveness. One of the main determinants of the competitiveness of human resources is a country's education system. The paper discusses EU activities related to achieving a move to a knowledge-based society and labour force competitiveness. After the introduction, a short theoretical framework is provided. The third part of the paper analyzes the situation in newly accepted EU members, in future members and in Croatia. After the assessment of some problems in Croatia, some proposals for improvements of the educational system are given.

\* *The author would like to thank the referees who anonymously reviewed this paper.*



110

**Key words:**

knowledge-based economy, education, labour force, European Union, Croatia

**INTRODUCTION**

Recent rapid advances in science and technology as well as globalisation pressures mean that modern economies are increasingly based on knowledge. The ability to create, distribute and exploit knowledge and information seems ever more important and is often regarded as the single most important factor underlying economic growth and improvements in the quality of life. Economic competitiveness depends crucially on how well countries and firms make use of their own intangible assets, such as employee knowledge, skills and creativity, know-how, and processes, as well as their ability continuously to improve those processes. The most important factors in labour-force competitiveness are the educational structure, and the compatibility of the demand and supply sides of labour in areas such as knowledge, expertise, ability and labour costs.

In the paper, the focus is put on EU activities related to the achievement of a knowledge-based society and labour-force competitiveness. After an introduction, we provide a short theoretical framework. The third part will give some international comparisons and analyze the situation in Croatia. The paper will also give some proposals for improvements of the educational system in Croatia.

**THEORETICAL FRAMEWORK  
AND EMPIRICAL EVIDENCE**

Wide-ranging knowledge and the education system are increasingly important under the current conditions of the global economy and a knowledge-based world. Education helps a country move up the ladder of development and prompts its transition from the production of simpler products to more complex items. A more educated labour force finds it easier to adopt foreign technology and to develop its own more rapidly.

*A knowledge-based economy* is one in which the generation and exploitation of knowledge play the predominant part in the creation of wealth. A knowledge economy is not an economy of scarcity, but rather of abundance because information and knowledge can be shared, and actually grow through application. A key component in a knowledge-based economy is human capital, or, more accurately, its competencies. In traditional industries most jobs require employees to learn how to perform routine functions, which, for the most part, remain constant over time. In the knowledge-based economy, rapid changes force workers constantly to acquire new skills and to update their skills throughout their lifetimes.

Barro and Sala-i-Martin (1995) have shown that the level of education (measured by years of schooling), as well as public sector allocations for education, exhibit a high correlation to growth in real per capita income. Highly competitive human resources result from a quality education that is available to a large percentage of the population. Bassani and Scarpetta (2001) found a significant correlation between an increased level of education in a country and the country's economic growth. According to their findings, an additional year of education for a country's population is associated with an average increase in output per capita by four to seven percent.

The value of formal education in and of itself should not be uncritically overestimated. Most researchers agree that human capital is an essential component of competitiveness and economic development (return on investment in education is greater than that of any other investment), but there is no a *guarantee* that the formal education structure accurately reflects real abilities and skills. The reasons for this are manifold. In general, the existence of a lot of people with (mostly obsolete) academic qualifications is not a true indicator of workforce competitiveness. The labour force can easily be insufficiently or inappropriately educated, i.e. the (formally educated) employed do not have the know-how necessary for successful market competition<sup>ii</sup>. Under conditions of rapid technological development and commerce based increasingly more on conceptual rather than on material production, academic diplomas and degrees are no longer a guarantee of economic success either to individuals or to society as a whole. Thus, firms can no longer rely solely on new graduates or new labour market entrants as the primary source of new skills and knowledge. Consequently, it is important to develop life-long learning and adult education programmes and ensure participation of the whole population.

In many developing and transitional countries the existing educational systems – with respect to the results – are expensive and ineffective, but there are no simple formulas to improve them. Here expertise is not sufficient: employees today have to be capable of creating, analyzing and transforming information, communicating effectively, and organizing and coordinating business activities. Developed communication skills, computer knowledge, and the ability and willingness to engage in further education and training are all sought-after qualities.

The biggest challenge for these countries is not just to get the hardware, but to have the skills required to use the technology. Educational systems can no longer emphasize task-specific skills but must focus instead on developing learners' decision-making and problem-solving skills and teaching them how to learn on their own and with others. The importance of tertiary education is especially great, as it directly influences the productivity and competitiveness of a national economy and the improvement of general living standards (World Bank, 2002). In short, the educational structure of a population and employees in line with economic needs constitute an essential component of competitiveness and economic development.

## THE SITUATION IN THE EUROPEAN UNION

The World Bank (2002) provided the following framework to help countries articulate strategies for their transition to a knowledge-based economy and society:

- an economic and institutional regime to provide incentives for the efficient use of existing and new knowledge and the flourishing of entrepreneurship;
- an educated and skilled population to create, share, and use knowledge well;
- a dynamic information infrastructure to facilitate the effective communication, dissemination, and processing of information;
- an efficient innovation system involving firms, research centres, universities, consultants, and other organizations, to tap into the growing stock of global knowledge, assimilate and adapt it to local needs, and create new technology.

We will dedicate more attention to the second item – an educated and skilled population to create, share, and use knowledge well –

keeping in mind the importance of the other three. Thus, we will analyse the activities in the EU (and new and future members of the EU) related to the education and improvement of the knowledge of the population and the labour force. We will point out the most important documents, strategies and bodies charged with the accomplishment of the goals set out above.

### European Union activities and documents

The Lisbon Strategy, commenced in March 2000 at the Lisbon Summit, set a goal for the next decade for the EU to become the most competitive and dynamic knowledge-based economy in the world, capable of sustained economic growth with more and better jobs and greater social cohesion.

The strategy focuses on EU competitiveness and cohesion in an increasingly innovative EU economy, creating more and better jobs. A new, open *method of coordination*, according to which member states define common objectives for delivery in the manner deemed most appropriate at national level, has been adopted for the implementation of the strategy. It was agreed that the European Council would meet regularly to review and push the process forward. The process of economic growth and EU cohesion were reviewed at the Economic Council in Stockholm 2001, Barcelona 2002, and most recently Brussels 2003 (European Council, 2004).

EU members are obliged to produce different implementation documents, like Operational Programme for the Information Society (OPIS), which is the main tool for creating and putting into effect an information society. Programmes usually include measures for the diffusion and better use of information and communication technology (ICT); these tend to consist of educational and research systems adapted to the digital age, increases in the quantity and quality of electronically provided government services for citizens and the business community, an increase in the productivity of the public administration, upgrading skills and the creation of new jobs, and the development of high quality and affordable broadband infrastructure and services. Direct activities cover a broad scope of measures from training teachers in primary and secondary education to use ICT, eBusiness adoption for small and medium enterprises (SMEs), and incentives for motivating and helping the employment of ICT in companies, especially in SMEs.

At the EU level, the results are positive, but there are huge differences between leaders in technology and competition (Finland and Sweden) on the one hand, and countries (or regions) that lag behind (like Greece or Southern Italy) and are trying to catch up with advanced societies on the other. Latter societies have so far shown ease in adapting to major technical and technological changes, but have difficulties in consolidating and disseminating them throughout the whole of society.

In 2002, in order to enhance education and labour force competitiveness, the Education Council adopted the *Work Programme*. The Programme includes three main objectives: improving the quality and effectiveness of education and training systems in the EU, facilitating the access of all to education and training systems, and opening up education and training systems to the wider world. Various measures are proposed for the realisation of particular objectives such as developing skills for the knowledge society, ensuring access to ICT for everyone, increasing recruitment to scientific and technical studies and strengthening European co-operation.

For all the mentioned objectives, the key is to keep labour market needs in perspective and to develop competencies for the knowledge economy. Countries that adequately prepare their human resources for active participation in the global knowledge and information economy will acquire a considerable advantage and stand most to gain. They will be pioneers in defining and determining the priorities for the future. Thus, the goal – to produce agile, risk-taking, independent thinkers with the skills to process information, solve problems and work independently and as a part of teams – is clear and indisputable. The way to get there is less clear. Also, there is no single blueprint suitable for all.

## International comparisons

Due to many differences in educational systems (like the mandatory duration of schooling, number of hours taught, the proportion of students in the total population, institutional frameworks or societal development), it is very hard – almost impossible – to compare the current situation in different EU members regarding the achievement of labour force competitiveness and educational results. Some conclusions could be obtained from the educational structure of labour forces in different countries. Regardless of its inconsistencies for comparative pur-

poses, information on the level of the highest educational attainment is currently the best available indicator of labour force skills. Table 1 shows the education attainment of the labour force aged 15 and over according to the latest sources for a selected group of countries. We selected some smaller EU members, some new members and some other South and East European (SEE) countries. Only three customary levels of education attainment are cited: primary, secondary and tertiary.<sup>iii</sup>

*Table 1 Share of labour force aged 15 and over (1999, in %)*

Country	Level of education attainment			Per capita GDP, based on PPS in 1999 (in USD)
	Primary	Secondary	Tertiary	
EU old members				
Austria	21.9	68.9	9.2	25,503
Belgium	33.6	35.7	30.6	24,485
Denmark	22.8	52.2	24.7	27,818
Finland (1998)	28.0	50.4	21.5	23,236
Greece (1997)	47.2	28.7	22.9	15,689
Ireland	34.7	27.7	33.8	25,680
Netherlands (1998)	31.7	42.8	22.5	26,289
Portugal	79.5	11.5	8.9	16,935
Sweden	21.3	49.4	28.5	23,300
EU new members				
Czech R.	9.8	79.0	11.3	13,450
Estonia (1995)	15.7	66.9	17.4	8,455
Hungary	19.7	64.8	15.6	11,417
Latvia (1997)	16.2	67.3	16.4	6,574
Lithuania (1996)	20.2	39.3	40.5	7,538
Slovakia (1996)	12.7	75.6	11.9	11,136
Slovenia	21.6	62.7	15.7	15,694
other SEE countries				
Bulgaria (1997)	27.3	53.4	19.3	6,216
Croatia (1998)	24.7	58.3	17.0	8,267
Romania	35.3	52.2	12.5	8,939

*Source: ILO (2002, Table 14a)*

*For GDP: OECD (2002).*

Although there are obviously differing classifications and interpretations for education attainment in these countries, the data are nonetheless surprising. Among selected old EU members, Ireland has

the highest share of tertiary degrees, while the lowest is in Portugal. Austria is just little bit better off, but this is mostly due to the classification of apprenticeship (widespread in Austria) into the *secondary* level – despite the fact that this will mean one or more years of study or training beyond the conventional length of secondary schooling in other countries. Secondary qualification attainment ranges from 12% in Portugal to almost 70% in Austria. Portugal has the highest share of primary qualification attainment, followed by Greece. Countries often mentioned as examples of very competitive labour forces, such as Ireland and Finland, have a relatively high share of primary qualification attainment, while Sweden and Denmark have the lowest share of primary qualification attainment.

If one neglects the unrealistically high share of tertiary qualifications and the related low share of secondary qualifications in Lithuania, the differences in educational attainment are less pronounced among the new members. In them, around 15% of the labour force has a tertiary qualification. Among the countries listed, the Czech Republic has the lowest share of primary and tertiary qualifications and the highest level of secondary qualification attainment. Slovenia has the highest level of primary qualification attainment, while in other countries it varies between 10% and 20%. Secondary qualification attainment in new members encompasses between two thirds and three fourths of the labour force.

Among the other SEE countries, Bulgaria has the highest and Romania the lowest share of tertiary qualification attainment, with Croatia in the middle. Croatia has the lowest share of primary and the highest share of secondary qualification attainment, while the situation is opposite with Romania. Among the other SEE countries, Bulgaria has the highest proportion of tertiary qualifications, and Romania the lowest, while Croatia is between them. Croatia has the lowest proportion of primary and the highest proportion of secondary qualifications, while the opposite is true of Romania.

Without underestimating or overestimating the importance of certain educational attainments in securing economic development and competitiveness, it is obvious that a better education structure is closely linked with a higher level of economic and social development, like per capita GDP and similar indices. Of course, the proposition that perhaps it was general economic development that enabled the enhancement of labour force educational attainments, not *vice versa* should not be neglected. Indicators only give a partial view of the reality. By their very nature, they only measure what can be quantified and things for

which there are data. It should not be forgotten that educational qualifications may be relatively easy to measure, but offer only a poor proxy for human capital. What one really wants is a direct measure of economically relevant skills, but unfortunately there is no possible candidate for this direct measure. As we only have data about *formally* acquired educational qualifications – the actual quality of individual educational programs and study courses is not being considered here – the share of the employed educational attainments can lead very easily to erroneous conclusions. Thus, tertiary qualifications are distributed fairly equally (approximately one fifth of the total labour force) in the technologically and institutionally very developed Netherlands on the one hand, and in Bulgaria and Croatia on another. Portugal has made great economic and technological progress in recent years, but it still has a relatively small share of secondary and tertiary qualifications.

Another possibility for assessing labour force competitiveness and educational results is the illiteracy rate of persons aged 15 years and over (Table 2). According to the UN, illiteracy is defined as the inability to read and write simple sentences about everyday life; hence, the semi-literate – those who can read but not write are sometimes included in the percentage as well. As illiteracy of adult persons is very low in industrialised countries, we provide information only for a few developed EU and transitional countries.

*Table 2 Illiteracy rate of persons aged 15 years and over (2001, in %)*

Country	Adult illiteracy rate
EU old members	
Greece	2.6
Portugal	7.3
Spain	2.2
EU new members	
Hungary	0.7
Latvia	0.2
Lithuania	0.4
Malta	7.6
Slovenia	0.4
SEE countries	
Bulgaria	1.5
Croatia	1.6
Romania	1.8

*Source: ILO (2002. Table 14e)*



Using the UN definition of illiteracy, developed countries usually have an overall illiteracy rate of about 1%. The Croatian illiteracy rate is reasonable and a little higher than this percentage, but lower than the rates in Greece, Spain and Portugal. Therefore, the situation can be considered acceptable. Although there are no precise statistics on the true scale of the problem, it might well be estimated that functional illiteracy – defined as an insufficient mastery of a set of sophisticated skills – is a serious problem in Croatia, as it is in even the most developed countries, where it usually encompasses above 5% of the total population<sup>iv</sup> (OECD, 1997).

*Table 3 Labour force and population aged 25 to 29 with completed tertiary education: latest available data (in %)*

Country	Percentage of labour force* aged 25-29 with tertiary education (year used as a source)	Percentage of population aged 25-29 with tertiary education (year used as a source)	Note for population <sup>v</sup>
EU old members			
Austria	9.0 (1999)	8.6 (1991)	1
Denmark	26.1 (1998)	18.5 (1995)	2
Finland	21.6 (1998)	18.0 (1992)	2
Greece	34.0 (1998)	14.9 (1991)	2
Ireland	47.0 (1999)	19.8 (1991)	2
Netherlands	30.6 (1998)	–	
Portugal	14.0 (1999)	12.6 (1991)	3
Sweden	31.9 (1999)	26.8 (1995)	3
EU new members			
Czech R.	10.2 (1999)	12.6 (1991)	3
Cyprus	34.1 (1999)	28.0 (1992)	3
Estonia	37.8 (1999)	–	
Hungary	13.3 (1990)	13.3 (1990)	5
Latvia	–	26.8 (1995)	3
Lithuania	40.8 (1999)	26.8 (1995)	3
Slovakia	45.8 (1999)	13.0 (1991)	3
Slovenia	19.7 (1999)	14.1 (1991)	3
other SEE countries			
Bulgaria	18.7 (1992)	19.7 (1992)	3
Croatia	14.5 (1991)	8.9 (1991)	4
Romania	14.3 (1999)	9.1 (1992)	3

\*The total labour force, or currently active population, comprises all persons who fulfil the requirements for inclusion among the employed or the unemployed.

Source: ILO (2002. Table 14c and 14d)

The third option for evaluating labour force competitiveness and educational results – though equally burdened with methodological difficulties – is the percentage of the of labour force and population aged 25 to 29 with completed tertiary or degree-level education (this should not be confused with the previously presented tertiary level of education attainment). Table 3 provides the data for some selected countries.

Although, due to many data problems, it is not possible to make straightforward and fully reliable assumptions, some conclusions about the current situation can be drawn. Regarding the share of labour force and the population aged 25-29 with degree-level education, Croatia is obviously lagging behind the majority of the old and new EU member states. The proportion of the labour force aged 25-29 with degrees or equivalent in Croatia is only one third of the proportions in Ireland or in the Slovakia. The differences are not as huge when one compares the whole population of the young in various countries, but still the proportion of people aged 25-29 with degrees in Sweden, Lithuania and Latvia is threefold bigger than in Croatia. The OECD average for the 25-64 year old graduate population (not only the young population) was 22% (in 1999), while for Croatia it was 11% (in 2001). Thus Croatia has only half the OECD share of tertiary completers because of the relatively low enrolment rate and low percentage of students that actually acquire degrees.

## THE SITUATION IN CROATIA

It is difficult to make an unequivocal assessment of the Croatian educational system because Croatia has not participated in international assessments of education and literacy. Even so, according to the OECD (2003) the considerable problems faced by the educational system can be cited with relative certainty: lack of emphasis on developing analytical and problem-solving abilities, very weak links between education and the professional world, and the non-development of life-long learning. Although numerous education strategies have been proposed, they have neither been put into operation nor fully implemented, nor were any major reforms implemented at any level.

In Croatia, the current organization of the curriculum around subjects and teacher-dominated learning methods, with the focus on factual knowledge and passive learning, is not conducive to the development of the high-level technical, technological, and social competencies needed

in a competitive economy. There are too many compulsory subjects and not enough optional subjects. There is a serious lack of flexibility and a low level of local capability for curriculum development.

A serious problem of elementary and secondary education is *insufficient differentiation*. The curricula for higher elementary grades are designed to continue on into secondary school (gymnasium), and not for continuation of schooling in vocational or trade schools (even though only one fourth of all elementary school pupils go on to study in the gymnasiums). Consequently, a great many primary school pupils suddenly find the primary school programme for the 7th and 8th grades too difficult, and the existing opportunities for internal differentiation are not sufficient. Accordingly, students who are very capable and motivated find subject teaching too easy, while those who are less competent and less motivated find it too difficult.

Vocational education forces subject-specific specialization too early, while the curriculum is too narrowly focused on subject-specific skills, competencies, and attitudes. Further, links with the economic and social environment are generally very weak. Due to technological developments and structural changes in the Croatian economy there is no longer a need for most of the existing specializations (OECD, 2003).

A considerable number of youths in Croatia *drop out* of secondary and higher educational institutions. According to a rough estimate, approximately 1.5% of enrolled students do not complete secondary school (this percentage is considerably lower for the gymnasiums, and palpably higher in the three-year trade schools)<sup>vi</sup>. This is, among other reasons, caused by a serious lack of a network of “second chance” schools, aimed towards young people who have either been excluded from education or are on the verge of exclusion. High drop-out rates drive up the costs per graduate.

Croatia’s tertiary system is so rigidly structured that institutions, faculties and students are unable to seize opportunities or adapt to change. One can say with relative assurance that the highly educated in Croatia have largely completed studies at university departments and academies that do not directly cater for the needs of a modern economy, and they often do not possess the vital and required knowledge and skill-sets for sought-after occupations.

*The number of those enrolled in tertiary education is relatively low.* It increased from 18% of the relevant age-cohort in 1985 to 31% in 1998, which is still considerably lower than in old EU member states (averaging around 50%) and individual Central and East European (CEE)

countries (averaging around 40%), although higher than in the most of the new EU members (averaging around 25%) (World Bank, 2002).

*The average duration of college/university study is very long.* The number of students who go on to earn degrees in relation to the number of students enrolled in the first year is less than 40%, while a large number of students discontinue their studies.

*The number of persons who graduated over the last decade increased* from 8,000 in 1993 to almost 15,000 in 2002 (and the total number of students also grew considerably – from 69,000 to 116,000). The highest growth in graduates was recorded in the social sciences and liberal arts; such graduates accounted for almost 57% of the total number of graduates. The proportion of graduates in the natural sciences also grew, but is still at the very low level of under 3% of the total number of graduates. The greatest decline was in the share of graduates in biotechnology, followed, to a somewhat lesser degree, by the medical and technical sciences, the percentage of which in the total number of graduates fell below 30.

*There is a relatively low proportion of students majoring in the natural and technical sciences.* The total number of students is 30%, which is significantly worse than Germany (47%), Turkey (45%), Slovakia (40%) and Slovenia (38%), and only a little better than the Czech Republic (28%), Bulgaria (26%) and Romania (21%) (World Bank, 2002).

*There are serious problems with the knowledge and skills of graduates in social sciences.* There is a serious shortage of macroeconomists, financial analysts, organizers and commodities- and securities-exchange operators, educated managers and entrepreneurs, international commodity and financial market experts, public administration experts, and lawyers specializing in labour and welfare law, the tax system, international law, etc<sup>vii</sup>. The reasons for these problems probably are caused by insufficient (or weak) links between the demand on the labour market and educational output.

The most dynamic sector of education systems in the world, *adult and life-long education, is almost completely neglected in Croatia.* It is underdeveloped, as far as the coverage of attendees, the number of specialized institutions, and specialized staff are concerned, and it is insufficiently regulated by law. In Croatia only 0.2 % of persons over 35 years old participate in one of the adult learning programs, while the EU average for the same age group is 7% (ILO, 2002). No (serious) campaign has been launched yet to motivate and explain the

concept and the need for life-long learning among the population due to relatively weak information and developmental infrastructure. The required infrastructure is undersized and some elements of the infrastructure simply do not exist, are yet to be built.

Croatia's education system, is slowly making the transition from a system that favoured rote-learning, discipline, and lecturing to a system that fits the needs of a democracy with a globally integrated free-market that needs problem-solving skills, creativity, communication skills, and flexibility. It should not be neglected that in Croatia some analyses and changes in education system have been made<sup>viii</sup>. The Croatian National Observatory is active in vocational and educational training and adult learning and tries to organise all stakeholders (Government, interested ministries, regional and local bodies and social partners) in providing a modern, quality, and affordable education.

## CONCLUSIONS AND RECOMMENDATIONS

Through the diffusion of new technologies and globalisation, industrial economies are being transformed into knowledge-economies accompanied by increased international competition. The important aspects of national economic competitiveness are the skill level and knowledge of the labour force. The Croatian labour force does not have the knowledge and skills required for a modern competitive economy, and the education and training systems have not yet taken adequate steps to remedy this situation. Possible accession to the EU puts further onus on Croatia to concentrate on its education system. The Croatian workforce should move towards knowledge-based industries and jobs and innovation-driven economic growth, and workers should be able to change jobs quickly, manage themselves and others, and engage in continuous learning. Students and employees should learn to work together by developing a team spirit and appropriate social behaviour while at the same time allowing their individual preferences and talents to develop.

Based on different surveys and studies by the World Bank (especially Berryman and Drabek, 2002) and OECD (2003) and comparisons with other European countries' education systems, we would like to propose the following recommendations:

- *The education system should be changed from supply to demand-driven, i.e. the system should provide learning alternatives that students*

(of all ages) can choose from, with increasing responsibility by students as they get older<sup>ix</sup>. Curricula and syllabi at all levels should be reformulated to bring them into closer correspondence with economic needs. Furthermore, the number of required courses should be reduced and the number of electives should be increased. Problem-solving abilities should be improved, teamwork should be encouraged, and learning skills should be enhanced. It is important to increase the ability to learn, develop students' capability to manage themselves and others, build communication and technical/ICT skills, and reduce the emphasis on rote-learning. Curricular reform should be accompanied by new textbooks, teacher guides and learning materials, changes in teaching methods, and new measures of learning outcomes. Also, specialization in vocational education should begin later (shifted to higher grades), while specializations should be broadened.

- *The educational system must be made more flexible*, so as to become a *navigable* system, thus avoiding dead-ends and lowering the early drop-out rate, increasing the internal differentiation of students, reinforcing informal methods of acquiring knowledge and skills, and improving knowledge of foreign languages. The systematic analysis, disburdening and modernization of educational curricula and programs are essential.
- It is important to make *the shift from teacher-focused teaching to teaching methods that give students responsibility for learning, reward initiative and executive thinking*, focus on alternative ways to analyze facts and ideas and solve problems in a meaningful context.
- *Management of the education system should be decentralized*, i.e. budgeting, personnel, and curricula, should be within the purview of the schools and local governments and universities instead of the Ministry. At the same time, schools and local governments must build the capacity to manage their schools effectively. Schools and universities should be responsible and accountable for their results and their performance should be measured by the success in the implementation of reforms. Increasing expenditures for education without an adequate rise in the accountability of those institutions will not provide expected results. Thus, the Government (Ministry) should set standards and hold schools accountable for learning outcomes, e.g. reading comprehension, information and communication technology skills, and give the schools and universities freedom to use their own methods to produce them. This will require nationally written, administered, and graded learning assessments.

- Government has the responsibility to put in place an enabling framework to encourage tertiary education institutions to be more innovative and responsive. *Government should facilitate private provision where possible, restricting its controls to the area of consumer protection.* These include quality assurance through mechanisms such as accreditation and impartial information about public and private institutions relevant to consumer choice.
- It will be necessary to *raise the enrollment quotas for specific majors in the natural and technical sciences, and increase the efficiency of studies* so that the largest possible number of enrolled students complete their studies. Curricula in universities should also be reformed to increase links with the needs of the economy, and dialogue and cooperation between the private sector and universities should be greatly intensified.
- *Higher tuition fees* could contribute to shorter average periods of study, and to greater fairness, because in this manner taxpayers, among whom there are those with lower incomes, would not bear the costs of educating persons whose future earnings will be higher than average.
- In conjunction with radical reforms of curriculum, materials, and pedagogy, Croatia will need vigorously to *train existing and new teachers* including imparting new teaching methods, use of teaching materials, and testing methodology. Teachers should be required to receive life-long training on teaching skills and methods, use of information and communication technology, and subject matter. The training should be interactive, with teachers sharing ideas and experiences.

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- i Here we refer to the labor force in the broader sense of a human resource, i.e. the employed and unemployed and inactive persons who can potentially be activated and employed.
- ii One should be aware that the concept of human capital is broader than just the formal education of a population and its employees, because it should encompass all knowledge and skills acquired informally and, under the broadest definition, investments in health. The level of human capital need not be the same as the average level of formal education. According to numerous OECD and World Bank sources, in many South American countries there is a high proportion of lawyers and literature and philosophy professors among their educated population, while in the Scandinavian countries there are many persons studying electronics, information technology, management, etc. (Blomström and Meller, 1991). This is not to negate the importance of the first group of the highly-educated, but the second group is nonetheless vital to economic development. Although there are no comprehensive and uniform solutions that suit all needs, the structure of pupils and students should

correspond as much as possible to the existing, and especially future, desired structure of the national economy. Simply put, if a country has a well-developed telecommunications hardware industry-like Finland with Nokia-then it is desirable to have as many electrical engineers and similar occupations among the students and graduates. If the economy is largely oriented toward tourism and providing services, or preserving historical and cultural treasures-such as Greece-then the emphasis could be on educating tourism managers, art historians, restoration experts.

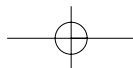
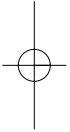
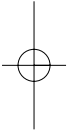
- iii Primary education – levels 1 and 2; secondary education – level 3; tertiary education – levels 5, 6 and 7. The accepted International Standard Classification of Education (ISCED) encompasses the following degrees: X – less than one year of schooling; 0 – kindergarten level; 1 – basic learning in reading, writing and arithmetic, and rudimentary knowledge of national history, geography, natural and social sciences, art, music and religion; 2 – slightly more knowledge of individual subjects and specific forms of commercial and technical subjects; 3 – includes specific forms of education requiring a full eight years of schooling; 5 – various forms of professional education, e.g. for technicians, teachers and nurses; 6 – university degree; 7 – graduate degree. Education not defined by level (Level 9) was for Denmark 0.3; for Ireland 2.0 and for Sweden 0.8%. There are some small differences in age group used for calculating population by education attainment. In some countries and situations, ISCED classifications are not strictly adhered.
- iv Even in Sweden, the country with the highest percentage of literate people, 8% of the adult population had a severe literacy deficit. In some other countries the percentage even rises to some 25%, so a huge part of the population is incapable of understanding and using the information contained in brochures, information bulletins and simple instructions for working place appliances (UNESCO, 2000).
- v Note for population: 1 – Age 25-35, de jure population; 2 – Age 25-29; 3 – Age 25-34; excluding population still in school and population whose level of education is unknown; 4 – Age 25-34, excluding expatriate workers and their families; 5 – Age 25-34, excluding population still in school.
- vi There is a serious problem with international comparisons of drop-out rates because there are no reliable data or they are not adequate for international comparison. Also, although drop-out rate data exist for some countries (for example Bulgaria around 6-7% of the total school population), there is the further problem of hidden drop-outs, the unexcused absences per year (around one-third of Bulgarian students). These children are often not accounted as drop-outs, but in reality they miss nearly one-half of their school time and inevitably their attainment is seriously affected (OECD, 2003).
- vii The mentioned conclusion is derived from different discussion with experts from Croatian Employment Service as well as the author's analysis of the trends on Croatian labour market.
- viii Thus, Institute for Social Research – Zagreb and Centre for Educational Research and Development, finished the Draft of Analysis on State Second School-leaving Examination that should enable a whole range of strategic objectives to be introduced into the educational system. These goals are important for its inner transformation and the permanent improvement of education quality. The Institute is also working on the projects Development of Lifelong Education Model for Teachers, Evaluation of Syllabus and Development of Curriculum Model for Compulsory Education, and Feasibility Study for the Compulsory Education Model.
- ix The long-term nature of education means that it cannot be driven by current demand only but has to meet latent or future demand as well. This effectively means that sup-





126

*ply side should also have its place in planning education needs. This is an obvious point given the limitations of the market in providing educational services. For this remark, the author is grateful to an anonymous reviewer.*



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## Chapter 6

# EVALUATION OF CROATIAN INNOVATION CAPABILITY

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## ABSTRACT

In this paper we try to assess and evaluate Croatian innovation capability thorough the framework of the European Innovation Scoreboard (EIS), a system of innovation indicators. Economic theory perceives innovation as a source of national competitiveness and the EU set the ability to compete within the single market as the main economic criterion for EU accession. Through the use of EIS indicators we are able to compare and rank Croatia's achievements in innovation policy against EU and Central and Eastern Europe countries (CEEC). Croatia ranks well by European standards in comparison to other CEEC, in particular Bulgaria and Romania, but has not made a significant progress in its innovation potential and policy with respect to the EU.

### **Key words:**

innovation policy, national innovation system, European Union integration processes, knowledge-based society, European Innovation Scoreboard, Community Innovation Survey, Croatia

\* *The authors would like to thank the referees who anonymously reviewed this paper.*

## INTRODUCTION

Croatia's economic policy has since the beginning of the transition devoted a lot of attention to macroeconomic policies and reforms, while innovation policy has developed under the umbrella of research and development (R&D) policy. This approach has neglected the potential of innovation policy to contribute to higher economic growth. The first elements of innovation policy in the form of technological programs appeared only few years ago. The focus of this paper has been placed, accordingly, on assessment of the elements and setup of innovation policy in Croatia. The paper consists of two major parts. In the first part, we explain why it is important to activate the national innovation policy and in the second part we try to recognize the strengths and weaknesses of Croatia's innovation potential and policy.

The significance of innovation policy for the economy has traditionally been recognized more strongly in advanced economies. In the Lisbon European Council in March 2000, the EU set out its long-term strategy of becoming the most competitive and dynamic knowledge-based economy in the world. Innovations are therefore perceived as a foundation of the transition to a knowledge-based society and innovation policy has become the central strategic tool in achieving competitiveness in industries and consequently, in the maintenance and stimulation of economic growth in the EU. In the light of the enlargement of the EU, all CEEC, including Croatia, must establish and develop a modern national innovation system (NIS). This should also help Croatia create the key conditions for achieving long-term economic development. We assess Croatian innovative capability through the European Innovation Scoreboard which consists of a number of standardized indicators of innovative performance.

Detailed analysis of Croatia's innovation policy and potential provides encouraging results in some areas of human resources development, for example, the share of science and engineering (S&E) graduates of the 20-29 year age class. However, another important aspect of human resource development – life-long learning – is totally neglected and sees Croatia at the end of CEEC and EU rankings. While the high-tech services sector appears relatively developed in Croatia, the high-tech manufacturing sector is clearly underdeveloped. Knowledge creation is an area where policies have obviously failed – expenditures on R&D, both public and business, are insufficient. Also, European Patent Office (EPO) applications by Croatian residents are the lowest in CEEC.

The transmission and application of new knowledge also require additional progress, especially in promoting a business innovation culture.

We conclude that Croatia has not made significant progress in its innovation potential and policy as compared to the EU, but by European standards ranks well in comparison to other CEEC, in particular Bulgaria and Romania.

## **INNOVATION POLICY: THE CENTRAL STRATEGIC TOOL IN ACHIEVING COMPETITIVENESS AND GROWTH IN EUROPEAN UNION**

The rise of the new economy formed in the context of globalization and the increasing importance of information and communication technologies (ICT), have pushed the EU to establish a long-term strategy to become the most competitive and dynamic knowledge-based economy in the world. The transition towards a knowledge-based society is perceived as a way of keeping pace with the EU's global competitors. At the Lisbon European Council Summit held in March 2000, innovations were perceived as a foundation of the transition to a knowledge-based society (Council of European Union, 2000a; 2000b). Therefore, innovation policy has become the central strategic tool in achieving industrial competitiveness and consequently, in maintaining and stimulating economic growth in the EU.

The EU approach to innovation policy is multifaceted. Elements of innovation policy are found in both industrial and enterprise policy. That attitude is reflected in the Lisbon Strategy (the official document of the Lisbon Council Summit), which proposes the establishment of a European Area of Research and Innovation and the creation of an environment friendly to starting up and developing innovative businesses. Small and medium-sized enterprises are seen as drivers of innovations. As a way of ensuring the achievement of these goals, the EU proposed the encouragement of key interfaces in innovation networks: between companies and financial markets, R&D and training institutions, advisory services and technological markets. The conclusions of the Summit are not likely to remain at the level of declaration, but are rather well envisioned in formal documents in terms of financial planning, effective monitoring, assessing and evaluating.

The importance of the strategic determination towards strengthening innovation processes in the EU is visible in the follow-up events. The Barcelona Summit in March 2002, where the European Council reviewed the progress made on basis of Lisbon Strategy, confirmed the commitment to fostering innovation and called for a more significant boost in overall R&D and innovation activities in the Union (Council of European Community, 2003d). In the conclusions, the Council expanded requirements for R&D spending (aimed to reach about 3% of GDP by 2010, with 2/3 of the investments coming from the private sector). Moreover, a call was made to strengthen business R&D through an integrated strategy involving increased competition on product markets, better access to venture capital, as well as better protection of intellectual property rights, and improved networking and technology diffusion. The Commission's Communication on Innovation Policy in 2003 also expanded policy conclusions based on the Lisbon strategy (Council of European Community, 2003d). The Communication asked for a broadly-defined concept of innovation, so that policy design would not omit less obvious or known types of innovation. It also demanded that innovation policy's interaction with other policy areas such as industrial policy be better coordinated and followed up.

In the Communication "Industrial Policy in an Enlarged Europe" innovation is outlined as a key factor of industrial competitiveness together with knowledge and entrepreneurship (Council of European Community, 2003c; European Commission, 2004c). The Communication states that European industry needs to become more innovative by constantly initiating, refining and improving its products, services and processes. The kind of innovation created through the development of a risk-taking mentality among entrepreneurs is stressed. The Green Paper on Entrepreneurship considers innovation one of the key challenges (Council of European Community, 2003a; 2003g). One of the priorities of the Paper is that innovation in the business context be promoted.

## **CROATIA'S INNOVATION POLICY IN THE LIGHT OF THE FUTURE EUROPEAN UNION ENLARGEMENT**

Croatia has since the outset of its political transition to democracy been oriented towards joining the EU and has throughout that

period made serious steps towards achieving its goal. In its answers to the Questionnaire of the European Commission in 2003, which later served as a base for obtaining candidate status for EU accession, Croatia put the establishment of a modern innovation system among its microeconomic and structural priorities. This is envisaged as helping Croatia to create the key conditions for achieving long term economic development. The modern innovative system that the country aspires to was defined as a system that encourages cooperation among the educational and scientific system, technology development, government institutions and private enterprises. The European Commission granted Croatia candidate status in 2004. In its *Opinion* on Croatia's application for EU membership (Council of European Community, 2004), the Commission regards Croatia as a functioning market economy. However, the Commission added that greater efforts had to be taken in the field of innovation policy to make the country competitive and efficient at the European level. Firstly, as an overall measure, government expenditure on research and development in Croatia (1.09% of GDP) is below the EU average (1.99%), as is the share of private sector expenditure on research and development (0.45% of GDP in 2002 in comparison with the EU average of 1.3%) (CBS, 2003). Secondly, changes are needed in scientific and higher education policies in order to integrate them into the European Research Area.<sup>i</sup> A national industrial strategy, which should incorporate elements of innovation policy in order to raise industrial competitiveness, has not yet been adopted independently of the general economic policy. The enterprise policy, another complement to modern innovation policy, is assessed as small and medium-sized enterprise (SME) policy in the formal documents. Innovation policy is integral to SME policy in that it has put forward the Croatian Innovation Technology Development Program (HITRA) specifically aimed to support technology transfer to new technology-based firms with financial and non-financial incentives.

On the national level, a politically independent advisory body that tries to foster and improve Croatia's competitiveness – the National Competitiveness Council (NCC) – put the development of innovativeness and technology as one of the top political and economic priorities. The Council perceives innovation as a permanent basis for maintaining competitiveness through productivity improvements. This view is in line with the EU's strategic determination to become a knowledge based-economy by fostering innovation. The results of the Council's work are embodied in a document entitled *55 Recommendations for*



*improving Croatia's competitiveness* which may serve as a basis for political decision making (National Competitiveness Council, 2004). In the document, innovation policy is addressed in terms of "what it should become" and not in terms of "what it is at the moment". Therefore, the Council outlined several principles that should help Croatia move towards a modern approach to innovation policy and as an outcome strengthen links among technology, innovativeness and economic growth. Those principles are designed for the establishment of a market-oriented innovation policy that will: strengthen components of innovation capability (absorptive capacity, demand, innovation diffusion and R&D), lead to productivity growth and strengthen the knowledge component in new investments.

## THE IMPORTANCE OF INNOVATION FOR ECONOMIC GROWTH AND COMPETITIVENESS

Understanding the theoretical links between economic growth, competitiveness and innovation could promote the role of innovation in Croatia's public and political life. There is a general consensus among economists that technological innovation plays a central role in the process of long-run economic growth (Radosevic, 2003a:4).

### **Innovations in economic growth theories and models**

While neoclassical growth theory did not elaborate how technological progress is achieved, although it perceives it as a source of growth, endogenous growth models have gone further. In endogenous growth models (models based on externalities, Neo-Schumpeterian models and AK models) technological progress continues to be the main source of growth, but technological progress is perceived as a result of activity of a particular entity – a firm or individual (Romer, 1986:1990).<sup>ii</sup> In models based on externalities, learning from other firms on the level of an economic branch leads to new ideas that may result in technological progress. Knowledge, which is considered identical to technological progress, cannot be protected, and is therefore free and can spill over. Neo-Schumpeterian models are based on a belief that research and development can spur economic growth (Grossman and

Helpman, 1990; 1991; Aghion and Howit, 1992). These models function under the assumption of imperfect competition. Under that assumption, firms will have an interest in innovating because now they can protect their innovations via patenting and earn extra profits. In AK models, growth is a consequence of capital accumulation, while technology is not treated as a special type of good, which makes these models less sophisticated than their predecessors.

Apart from their concern for growth, transition economies have shifted their focus towards competitiveness, particularly so in the light of the need to catch up with the EU as well as of withstanding competitive pressures within the Union (Radosevic, 2003a). The role of innovation for the success of a nation and its industries is discussed in Porter's work embodied in "The Diamond of National Advantage".<sup>iii</sup> Porter (1990:73) recognizes that competition revolves around the creation and assimilation of knowledge. For him, a nation's competitiveness depends on the capacity of its industry to innovate and upgrade.

#### **Porter's approach to innovation**

Although Porter asserts that the national success of various countries can derive from combinations of different factors, he determinedly dismisses widely held beliefs that government policies such as an active exchange rate and antitrust policy will spur an economy. Instead he turns to the examples of industries that have succeeded on the global scene and asserts that companies achieve competitive advantage through acts of innovation (Porter, 1990:74). At the individual firm level, innovation is not only perceived as introduction of new technology (resulting in new products) but can also be seen as innovation in processes and organization (new in-house processes). However, the international dimension of innovation is stressed – innovations must be marketed internationally in order for firms to be considered to have a competitive advantage. Porter believes that successful innovations will arise when companies are under strong competitive pressure, irrespective of their innovative activity perhaps being faced with criticism and significant obstacles. Keeping the competitive edge is seen as a continuous process of improvement and upgrading. This is due to the fact that competitors are likely to be able to imitate any given competitive advantage.

## INNOVATION CAPACITY IN CENTRAL AND EASTERN EUROPE

Strategies for achieving and maintaining long-term economic growth in CEEC during the 1990s disregarded the role of R&D systems or the role of innovation activities. Public innovation policies only emerged at the end of the 1990s, while institutional R&D systems have still not been restructured. Growth and innovation in an economy generally depend on R&D, on the capability to absorb and diffuse technology and on the demand for its generalization and utilization – elements which form the conceptual framework of a national innovation capacity (NIC).

### Elements of national innovation capacity

(1) *Absorptive capacity* is the ability to absorb new knowledge and adapt imported technologies. (2) *R&D capability* is important not only to generate new knowledge but also as a mechanism to absorb it. (3) *Diffusion* is the key mechanism for reaping economic benefits from investment in R&D and for increasing absorptive capacities. (4) *Demand for R&D and innovation* is the key mechanism that initiates wealth generation processes in R&D, absorption and diffusion activities (Radosevic, 2003a:8).

A large base of research scientists and engineers coupled with a relatively well educated working force were two strong starting points of national innovation systems in CEEC.

*A National innovation system* is a system consisting of: policy measures and programs, technological institutional infrastructure and policy control mechanisms (Švarc, 2004).

The institutionalized R&D base has shrunk over the transition period due, on the one hand, to the decreasing amount of R&D public expenditure as a proportion of GDP, and on the other, because there has not been sufficient technological upgrading in firms. The financing of institutionalized R&D by industry was quite diverse across the region, ranging from strong connections to utterly weak and the intensity of that cooperation was determined by the country's industrial structure. Deindustrialization in some CEEC was quite abrupt, with services taking stronger shares in the economic structure, and at the same time growing above the industry average. Overall, partial loss of government

funding together with weak demand from the industry have pushed the modernization and restructuring of R&D systems into neglect.

CEEC is lagging behind the EU in all aspects of NIC and most pronouncedly in its capacity to generate demand for innovation, which may be defined as the level of the development of the financial system, the degree of competition and macroeconomic stability or shares in foreign direct investment (FDI). Evidence on the state of NIS in former candidate countries points to strong disparities (Council of European Community, 2003a:11). In comparison to the former EU-15, the new members (as of May 2004) had pronounced aversion to risk, underinvestment in R&D and poorly developed science and research-business links. It appears that all of the new members have a common difficulty in the area of innovation policies, which have not yet become autonomous, fully-fledged policies. The institutional setting for implementing innovation policy is not well coordinated, human and financial resources are scarce, and the capacity of businesses to absorb knowledge and then apply it is low.

Consequentially, the relationship between domestic innovative activity and economic growth from a sample of eight CEEC is unclear (Radosevic, 2003a). It appears that frontrunner economies (the Czech Republic, Slovakia, Hungary and Poland) are not the countries with the highest number of registered resident patents. That would imply that innovations are not a driving force behind growth in CEEC. Also, the causality from economic growth to innovation is not straightforward. Both economic rise and decline have in the past led to a decline in R&D, suggesting that higher economic growth may not necessarily lead to higher innovative activity. Improved goods and services demand and supply conditions in CEEC at the end of 1990s might have contributed to the larger adoption of new technologies, but that did not happen. Apart from recognizing that domestic firms had difficulty in financing their activity, strong "brand" competition (though trade and FDI) might have also hindered catching-up in technology.

When examining the cost structure of innovative activity in CEEC, it seems that R&D is less important than buying new technology, while the trend is quite the opposite in the EU, where R&D has larger share in innovation expenditures than the acquisition of new technology. The business environment is the main source of innovation information, and not information within the firm (which is the case in more developed countries). A part of this business environment consists of foreign investment enterprises (FIE) – and world estimates are that

most new innovations occur in multinational companies (MNC). However, it seems that the transfer of technology from MNC in CEEC was confined to FIE (cf. Biegelbauer, Griebler and Leuthold, 2001). Transfer of technology from FIE to local firms might have occurred only in the countries that have received the most significant shares of FDI into export-oriented internationalized activities such as the automobile or electronics industry and where FIE have worked with local suppliers and contractors (Poland, the Czech Republic and Hungary). Radosevic (2003b:9) points out that corporate reliance on external information and the external setting raises the importance of NIS – since innovation capabilities of firms are dependent on the systemic features of the external environment in which they operate.

## CROATIAN INNOVATION POLICY

The first elements of innovation policy in Croatia only emerged in late 1990s (Švarc, 2004). The reason behind the marginalization of innovation policy can mostly, on the one hand, be attributed to the importance given to macroeconomic policy, in particular to macroeconomic stabilization and reforms, monetary and fiscal policy objectives etc. On the other hand, the understanding of innovation policy in Croatia was obsolete and traditional in that it perceived that innovation policy should primarily be based on fundamental research. That traditional view hindered the development of the applied sciences and their commercial use as well as postponing the modernization and reorganization of the general research and science institutional setting and policies. Evidence to that effect is found in the fact that the Ministry of Science and Technology was the sole body responsible for innovation policy, but perceived it as technological and science policy from the beginning of the transition to the late 1990s.<sup>iv</sup> On the positive side, the traditionalist approach to science and technology prevented the diffusion of a broad knowledge base. The government was mostly focused on the modernization of higher education, but with no consequences to the science and research system which under Government financial support remained non-autonomous. The National Science and Research Program of 1996 served as a formal base for setting up the first network of institutions for technology transfer. The centers were founded in Zagreb, Rijeka, Split and Osijek with the mission to serve as institution-technology interface centers between universities and business commu-

nity. The Program from 1996 also envisaged the creation and implementation of measures for innovation-based businesses.

The research “market” was also impoverished by the disappearance of many industrial institutes, which had been the driving force behind technology and innovation development in the past, as they were left to the care of the market and their founding companies. As a result, only a few of those institutes remained alive and successful. The turning point in innovation policy development was in early 2000, when programs promoting cooperation between industry and R&D systems were introduced. The HITRA was launched in 2001 by the Ministry of Science and Technology and it aimed at building up an efficient NIS through permanent development of three strategic long-term goals: (1) the creation of stimulative policy measures, mechanisms and programs; (2) the creation of a technological institutional infrastructure and; (3) the establishment of control mechanisms of policy for innovation and technology (National Competitiveness Council, 2004). It was with these programs that the development of entrepreneurship and the technological upgrading of firms was specifically targeted. The introduction of these programs was a step towards a modern approach to innovation policy that is found in the Triple Helix model, which consists of three basic actors intertwined in their actions – the government, universities and businesses – the goal being to shorten the time span between discovery and utilization.<sup>v</sup> Nevertheless, the programs did not manage to strengthen the whole all of the elements of the model, and in particular they have failed to promote links between R&D and businesses. The element of the model that was most promoted is the link between the Government and the R&D sector. So far, the Croatian NIS has been characterized as having a weak sector of industrial R&D and low level of technological capabilities of business. Implementation of HITRA and its contribution to the development of the Croatian NIS has so far been insufficient.

Considering the fact that innovation policy has been operational only over the last four years, its estimated impact on research and development, and in consequence on economic growth, could only have been modest and therefore, will not yet be visible.

## METHODOLOGY AND DATA

The theoretical framework of technological changes assumes that there is an R&D sector which, in interaction with demand for R&D

by innovators, generates innovations (Radosevic, 2003a:5). Our goal is to examine the state of demand for innovations and the pool of innovations in Croatia and make a comparative analysis with the EU and its new members. We use the EIS as a framework of our analysis. It was originally created for tracing progress towards the EU's strategic goal of becoming the most competitive and dynamic knowledge-based economy in the world (European Commission, 2004:4) and it consists of 17 indicators divided into four categories relevant to the innovation process. Those categories are: human resources, knowledge creation, transmission and application of new knowledge and innovation finance, market and output. Countries already included in the Scoreboard's sample are the EU-15 and the new members of the EU as of May 2004 and Bulgaria and Romania.

*Human resources* is a category that approximates the quality scale of human resources as a major determinant of knowledge creation and the transmission and application of new knowledge.<sup>vi</sup> This category is recognized as the most important source of knowledge in particular countries. The human resources category includes five indicators divided into two groups: education and learning, and employment. The indicators related to education and learning are: percentage of S&E graduates of the 20-29 year age class in the population, the percentage of the population with tertiary education, and participation in life-long learning. The group related to employment comprises two indicators: the number of employed in medium and high-tech manufacturing and the number of employed in high-tech services.

*Knowledge creation* as category measures inventive activity. Knowledge creation as a process enhances inventions which are prerequisites for innovation activities. Its indicators are: public R&D, business R&D and patenting. Patenting has two sub-categories (1) high technology patents at the EPO and high technology patents at the US Patent Office (USPTO) and (2) EPO applications (per million population) and USPTO applications (per million population).<sup>vii</sup>

*Transmission and application of new knowledge* presents a link between an invention concept (a thing or an idea) and an innovation term (introducing new things, ideas or way of doing something). Transmission and application of new knowledge as category covers innovation activities such as the adoption of new equipment to a firm's production and service systems, adopting innovations developed by other firms and organizations, and adapting new knowledge to the firm's specific needs (European Commission, 2001:6). This category includes

the indicators: SMEs innovating in-house manufacturing, SMEs involved in innovation co-operation and innovation expenditures.

We start by compiling indicators for CEEC available to us from the Scoreboard Report and set their values of indicators against the EU average value in 2003.

Due to the unavailability of data for Croatia in the Scoreboard's category *Innovation finance, market and output*, we omit this category and focus on an analysis of the series of 12 indicators comprised in the other three categories: human resources, knowledge creation and transmission and application of new knowledge.

Data for constructing Croatia's indicators are collected from sources at both macro and micro-level. Macro-level data are taken from the Central Bureau of Statistics (CBS), ministries and government agencies. Firm-level data are available to us from the preliminary results of the Croatian Community Innovation Survey (CIS) carried out within the framework of "Statistics of innovation in the Republic of Croatia" (mimeo) project by The Institute of Economics, Zagreb.<sup>viii</sup> Surveys of this kind have already been conducted in over 30 European countries and are aimed at collecting innovation activities data and usually serve as statistics bases available to innovation policy makers. The statistics include manufacturing and service sectors data on product and process innovations, expenditures on innovation activities, in-house research and development.

The Croatian CIS is carried out in 3,749 firms with over 10 employees belonging to the sections of Mining and Quarrying, Manufacturing, Electricity, Gas and Water Supply, Transport, Storage and Communication, Financial Intermediating and subsections: Computer and related activities, Research and development, Architectural and engineering activities and related technical consultancy, Technical testing and analysis.<sup>ix</sup> The period under observation is 2001-2003. The sample used for the purposes of constructing indicators in the transmission and application of new knowledge category is smaller than in the other categories and amounts to 600 firms. We expect the final values in this category to be lower than the preliminary ones that we are using.

In our analysis, we are forced to adapt the framework of Scoreboard indicators because an application of a single methodology across the sample of countries is not possible. The analysis will allow us to rank Croatia against EU countries and other accession countries in the monitoring period and assess the country's progress towards EU in the area of innovation activities and technological changes.



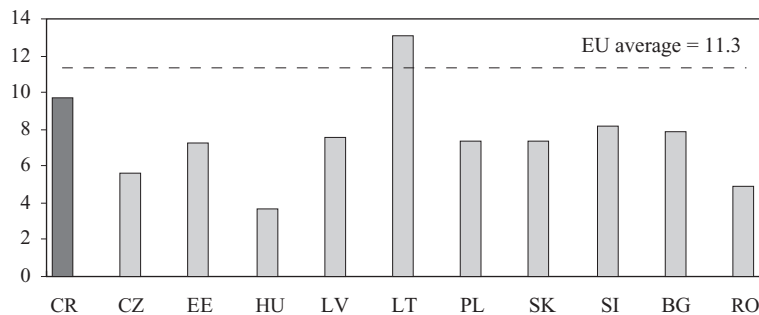
## INDICATORS ANALYSIS

### Human resources

The first category of indicators is related to the state and potential of human resources. They approximate achievements in education and life-long learning and are combined with employment in medium-high tech industries and services.<sup>x</sup> Within this category, Croatia ranks relatively well in comparison to the rest of the CEEC as well as in comparison to the EU average.

*Science and engineering graduates indicator* is a measure of the supply of new graduates with training in S&E. This indicator is used as a broad educational category. According to the average value of the indicator S&E graduates, three groups of countries differ in progress across EU. The first group represents countries with higher values than EU average with the “European tiger” Ireland standing out with over 90% more graduates in S&E than the EU average. France, the United Kingdom and Finland follow. Finland and Ireland’s economic successes have often been attributed to the countries’ devotion to university education. Nonetheless, one of the biggest and most successful European economies, Germany, has a lower value than the EU average.

Figure 1 Science and engineering graduates\*



\* % of 20-29 years age class

Source: European Innovation Scoreboard, authors' calculation, based on CBS (2003)

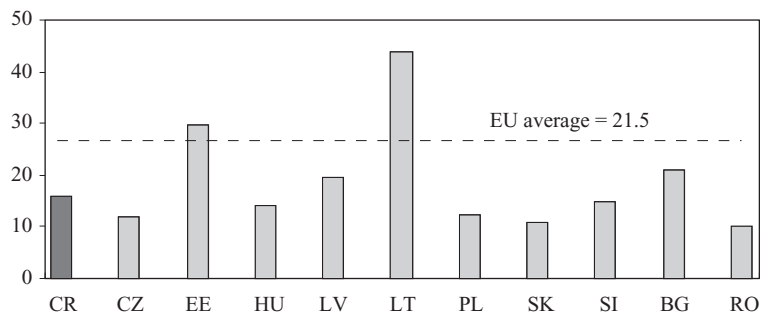
All of the CEEC except Lithuania have fewer S&E graduates than the EU average. The value of the Croatian indicator is slightly

lower than the EU average, and places the country in line with Belgium and Germany, which belong to the lower value group. Croatia is leading, with Lithuania, among CEEC.

*Population with tertiary education indicator* represents a general indicator of the supply of advanced skills (European Commission, 2003:8). On average, 21% of population in the EU has completed a university program. Finland and the UK again stand out as countries with even higher shares of the population with a university degree, implying that their educational systems produce a large advanced-skills base for industries.

The position of Croatia compared to the EU average shows an unfavorable situation because only 15.9% of population has tertiary-level education, which is 26% lower than the EU average. Lithuania and Estonia have managed to fall into the above-EU average group, while Bulgaria's indicator is near the average.

Figure 2 Population with tertiary education\*



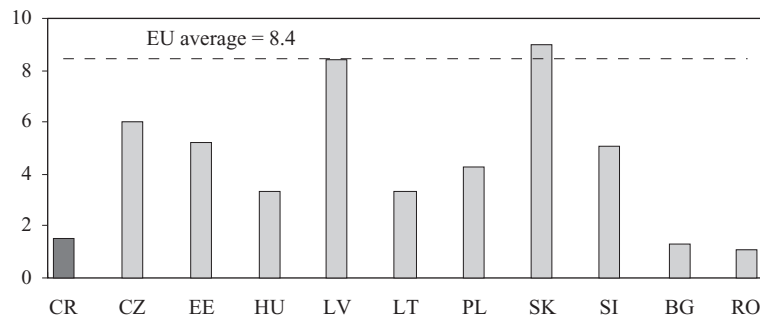
\* % of 25-64 year age class

Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)

*Life-long learning* presents continuous learning of new ideas and skills (European Commission, 2003a:10). The UK (with the Scandinavian countries) manages to lead in the EU with the highest share of participation in life-long learning. Life-long learning presents the most critical problem for Croatia in the human resources category. Not only is the value of this indicator far below the EU average, but is also far below all of the new members' values. The only countries with more critical values are Greece, Bulgaria and Romania – all of which

are countries with high rates of unemployment. It appears that education in Croatia is still focused on elementary and secondary education, putting emphasis on outmoded methods and teaching techniques of a narrow range of basic skills (cf. National Competitiveness Council, 2004:21). Also, the links between high education and businesses are underdeveloped, which hinders the accumulation of mutual benefits provided by life-long learning.

Figure 3 Participation in life-long learning\*



\* % of 25-64 years age class

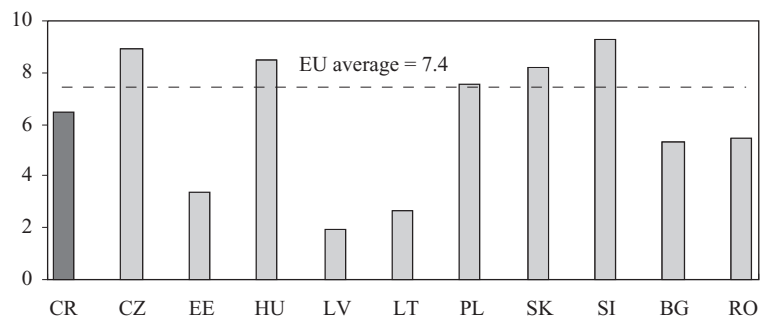
Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)<sup>vi</sup>

If we accept the argument that the level of education quality and participation in life-long learning processes are determinants of national competitiveness (National Competitiveness Council, 2003:54) then the Croatian competitive stance is vulnerable in comparison with EU and other CEE countries.

*Employment in medium-high and high technology manufacturing* is considered crucial for economic development because it includes sub-sectors with great innovative potential frequently accompanied by business success. In the EU, Germany is the only country with a value higher than the EU average value. The rest of the old members' values are near the average (Finland, Italy, Sweden, etc.). Employment in medium-high technology manufacturing in CEEC is very high and above the EU average in the most progressive new EU members: the Czech Republic, Hungary, Poland, Slovakia and Slovenia. Croatia lags behind these progressive countries, but has a better position than

Bulgaria and Romania. Croatia's indicator value is similar to results obtained from analysis of employment in manufacturing where Croatia had worse results than the Czech Republic, Slovenia and Hungary, but was better off than Bulgaria (Vidovic, 2004: 21). Perhaps this can be explained by the shrinking of the previously strong industrial base in Croatia, while both in Hungary and the Czech Republic this base was strengthened with inflows of export-oriented FDI.

Figure 4 Employment in medium-high and high technology manufacturing\*



\*% of total workforce

Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)

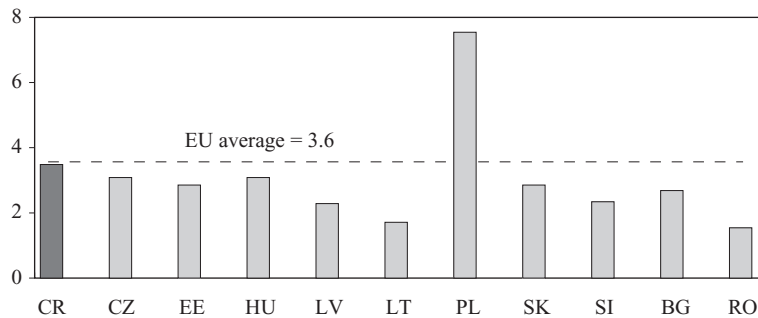
The importance of the *employment in high-tech services* indicator lies in fact that high technology services both provide services directly to consumers such as telecommunications and provide inputs to the innovative activities of other firms in all sectors of the economy (European Commission, 2004a:11). Employment in medium-high tech industries and services also indicates the potential for catching-up, which is easier if economies are specialized in technology-intensive sectors (Radosevic, 2003b:9).

Interestingly, countries that push the EU average up are mostly smaller countries, and not surprisingly some of them have been shown to have a large base of S&E education; among them are the Scandinavian countries, the Netherlands and Ireland. This indicator is one of those where the CEEC seem to be catching up with the EU or faring well generally. Poland in that respect is leading in the share of population employed in the high-tech service sector. All other CEEC are lagging behind the EU average, Croatia being close to that average

146

with 6.4% of employed in medium-high and high technology manufacturing.

Figure 5 Employment in high-tech services\*



\* % of total workforce

Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)

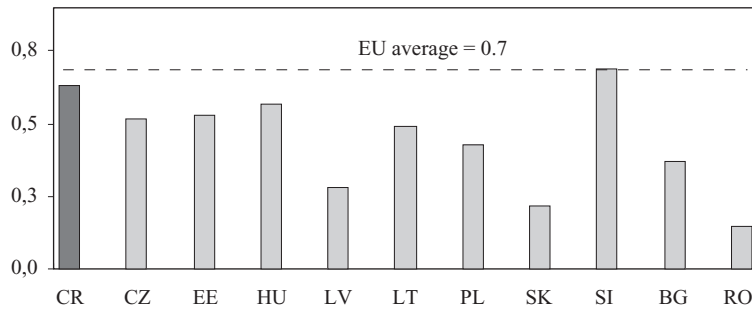
## Knowledge creation

According to the values of indicators falling into this category, CEEC are not competitive with the EU in knowledge creation. Croatia ranks unfavorably in all of the indicators, and has not managed to reach the EU average in any of the indicators.

*Public R&D expenditures indicator* is calculated as the difference between Government Expenditures on Research and Development (GERD) and Business Expenditures on Research and Development (BERD). Its great importance lies in fact that public R&D represents the foundation of every national scientific system and national innovation system. Systems of innovation in the modern sense are made up of interaction between the R&D system, firms and the government.

Slovenia as the credited frontrunner among CEEC has succeeded in getting its expenditures to reach 0.7% of GDP, which is the EU average. Generally, Slovenia takes the lead in all of the indicators in the category of knowledge creation, thereby manifesting the convergence with the EU it has achieved in this respect. Croatia slightly lags behind Slovenia in public expenditures on R&D as percentage of GDP, but is far ahead of the other CEEC and only 8.7% below the EU average.

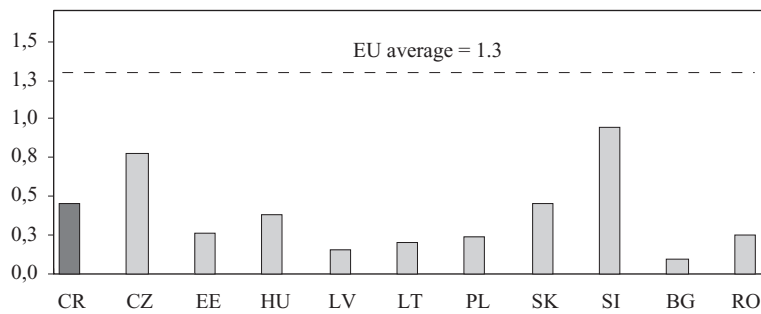
Figure 6 Public research and development expenditures (% GDP)



Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)

*Business expenditures on R&D indicator* captures the formal creation of new knowledge within firms. It is particularly important in science-based sectors (pharmaceuticals, chemicals and some area of electronics) where most new knowledge is created in or near R&D laboratories (European Commission, 2003a:18). Again, Finland and Sweden take the lead and are the countries where firms spend the most on R&D. Taking into consideration that private sector development is still taking place in CEEC, the low values of the indicator for CEEC are not unexpected. Although Croatia ranks well among CEEC, its position in comparison to the EU average is disadvantageous.

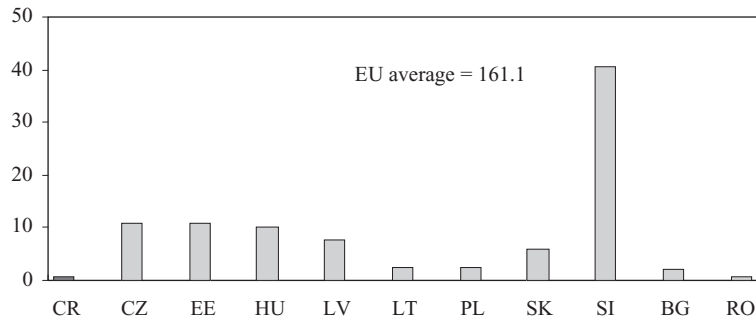
Figure 7 Business expenditures on research and development (% GDP)



Source: European Innovation Scoreboard, authors' calculation based on CBS (2003)

*EPO applications* indicator covers all applications at the EPO (European Commission, 2003a:24).<sup>xiii</sup> The analysis of EPO applications shows that all CEEC values are significantly lower than EU average value. Slovenia, with the highest number of applications is still only 74.7% of the EU average. The public notion of the number of patents and success achieved in their application in Croatia is more favorable, thanks to the intense promotion in the media, than its real position in international terms. This is visible in the low application of those innovations according to EPO standards. The value of this indicator for Croatia is critical, placing the country at the end of the CEEC and making it the least competitive country in that respect. There are two reasons behind Croatia's unfavorable position in EPO statistics. The first one is the low share of legal entities in patent applications at the national level. Legal entities in the 1992-2002 period filed only 12% of total patent applications, while the rest were filed by natural persons (SIPO, 2003). Despite the high share of public expenditure on R&D in Croatia, its BERD is low (0.45% of GDP in 2002), while in Slovenia, which also has a high level of public expenditure on R&D, BERD is more than double that of Croatia (0.94% of GDP in 2002). The second reason is the lack of financial provisions for the breakthrough of Croatian patents into the international market, especially through EPO.

Figure 8 European Patent Office applications\*



\* per million population

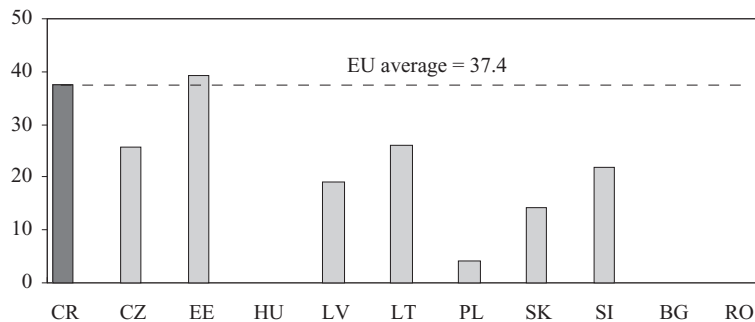
Source: European Innovation Scoreboard, estimation (Croatian Patent Office)

## Transmission and application of new knowledge

The overall performance of CEEC indicators in the category of transmission and application of knowledge can not be characterized as successful or unsuccessful.<sup>xiii</sup> It is the individual performance of countries that marks the stance of CEEC in this category and it is not the frontrunners that necessarily deliver the best results. Croatia ranks fairly well in this category relative to both EU average and the CEEC values.

*SMEs innovating in-house indicator* measures the degree to which manufacturing/services SMEs that have introduced any new or improved products or production processes, have innovated in-house (European Commission, 2003a:28). Only Croatia and Estonia exceed the EU average of SMEs innovating in-house. Croatia's indicator value places the country in line with Austria, Portugal and Sweden.<sup>xiv</sup> The high value of the indicator for Croatia can perhaps be explained by the fact that new investment is by definition any investment into a new product, i.e., a product that is new to the domestic firm. This innovation may, however, be a product that is new to the firm and has actually been introduced via imports.

Figure 9 Small and medium-sized enterprises innovating in-house\*



\* % of manufacturing/services SMEs

Source: European Innovation Scoreboard, authors' calculation based on CIS (2004)

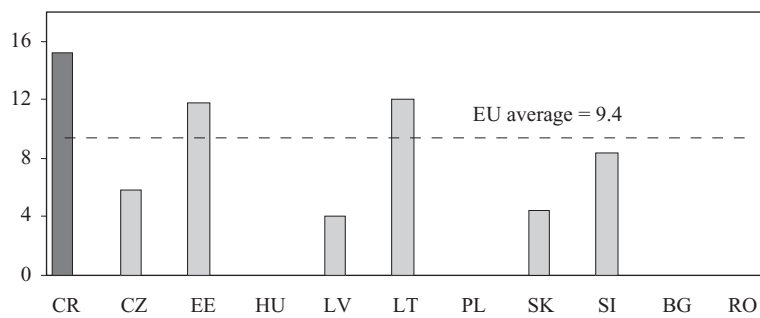
*SMEs involved in innovation co-operation indicator* measures the degree to which manufacturing SMEs are involved in innovation co-operation. This indicator measures the flow of knowledge between public research institutions and firms and between a firm and other firms (EC, 2003a:30). Manufacturing and services enterprises are most frequently involved in innovation co-operation in the Scandinavian



150

countries. This also seems to be the case in Croatia, which among CEEC has the highest value of the indicator – about the same as Sweden. Explanation of this surprising result may lie in the fact that Croatia had a substantial manufacturing tradition (Vidovic, 2004:6).

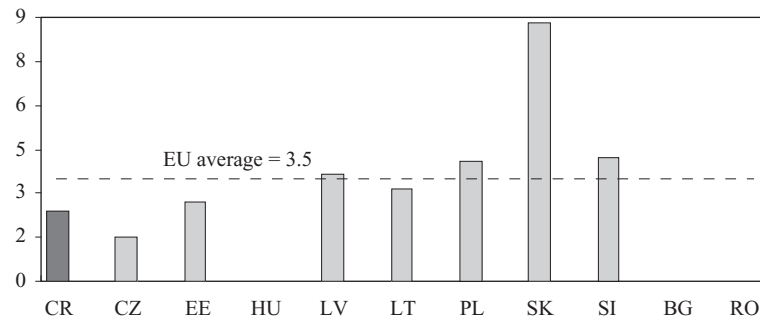
Figure 10 Small and medium-sized enterprises involved in innovation co-operation\*



\* % of manufacturing/services SMEs

Source: European Innovation Scoreboard, authors' calculation based on CIS (2004)

Figure 11 Innovation expenditure\*



\* % of all turnover in manufacturing/services

Source: European Innovation Scoreboard, authors' calculation based on CIS (2004)

*Innovation expenditures indicator* measures total innovation expenditure as a percentage of total turnover in manufacturing and services (European Commission, 2003a:32).<sup>xv</sup> Some CEEC have managed to surpass the average EU value in this indicator. Most pro-

nouncedly, this is the case with the Slovak Republic, the value of whose indicator exceeds the EU average by 55%. Croatia's stance in this respect is quite unfavorable as the country ranks at the end of CEEC.

## CONCLUSIONS AND RECOMMENDATIONS

The goal of our paper was to evaluate the state of Croatia's innovation capability in the light of integration into the EU. Croatia has not made any significant progress in its innovation potential and policy with respect to the EU, but by European standards ranks well in comparison to other CEEC, in particular Bulgaria and Romania.

The country's stance in some aspects of human resources development only appears encouraging. For example, the share of S&E graduates of the 20-29 year age class is high, but in fact only reflects the orientation of the Croatian educational system and not the quality. However, another important aspect of the development of human resources – life-long learning – is totally neglected and places Croatia at the end of CEEC and EU rankings. The absence of any links of cooperation between universities and the business sector could be a reason behind this. Therefore, greater attention should be paid to the inclusion of principles of life-long learning into the educational system, which is also promoted by NCC. Promotion of life-long learning, in particular, among the vulnerable groups in population (the unemployed), could also help achieve a better match between labor supply and demand for labor.

Also, the links between the vast national R&D base and educational system and businesses need to be reestablished and promoted. Knowledge will have to be applied and used commercially more in the future, as opposed to the present state in which there is no incentive to turn to the market. A transformed market-oriented research and educational system will be forced to monitor the signals from the market and improve its capacity to supply innovation. However, shock-therapy which would leave the national university and research system to dependence on the market entirely is not a desirable approach in this matter. It would result in a shift from one extreme to another – from emphasis on fundamental research to emphasis on applied research. In that case international excellence and success of the institutions may be publicly acknowledged and ranked.

While the high-tech services sector appears relatively developed in Croatia, the high-tech manufacturing sector appears underdeveloped.

Knowledge creation is an area where policies have obviously failed – business expenditures on R&D are insufficient, which can also explain why EPO applications by Croatian residents are the lowest in CEEC. At the moment, most of patents at the national level are registered by individuals (88%) while the trend is the opposite in the EU, most new patents being registered by the business sector.

Croatia will have to make stronger efforts in innovation policy implementation, but also in coordination with other areas of economic policy – in particular, science and technology policy, SMEs policy and industrial policy. All of these policies must complement each other in facilitating improvement in innovative output. Small economies must nurture the development of small firms and moreover – concomitantly with science and technology policy – strengthen industrial and research centers and technological centers so that the innovation process has more chance to take place.

In the end we could recommend the following.

*Goals and targets of an innovation policy should be set explicitly.* Croatia must, on the one hand, converge with the EU, and on the other hand, prioritize its own economic development. Innovation policy can serve as a tool to achieve both goals. According to the EU model, the goals and targets of the policy should be set explicitly. Croatia's political commitment to integrate with the EU carries an obligation to come up with a National Development Plan (NDP) before integration. That opportunity can be used to prioritize the development of innovation potential and the implementation of innovation policy. The Office for the Development Strategy has already been considering innovation policy as an integral part of the NDP and should therefore be responsible for designing innovation policy targets. Those plans should be compatible with those already carried out by the ministries responsible for innovation and enterprises: the Ministries of Economy, Science, Education and Sports, and of Finance.

*Stronger implementation of programs in the field of innovation policy is called for.* Innovation policy needs to coordinate complementary activities in the technological sphere and the potential stakeholders must be aware of the existence and the benefits of those activities. Programs in the field of innovation policy like HITRA were well envisaged, but their implementation was weak due to insufficient coordination between the government, universities and businesses. Such a situation could not have led to stronger political pressure and wider recognition of the importance of the innovation policy. The existing pro-

grams need to be implemented more strongly and control mechanisms need to be improved, which would bring wider social benefits. Such a change would result in wider public attention and acknowledgement of the innovation policy.

*Obstacles to financial instruments for financing innovations should be removed and access to them eased.* Investment into business R&D may be given incentives to grow through increased access to financial instruments especially through non-loan forms of financing such as venture capital. A quantitative goal may be set to correspond to the goals of the EU in this policy field: for investments into R&D sector to reach 3% of GDP in a reasonable period of time. The EU stipulates that most of that investment should come from the private sector. An alternative route to reaching that goal should be the widening of R&D subsidy base to include enterprises. The application of Croatian patents at the European level (EPO) is extremely low. This unfavorable situation may be changed through promotion of patenting in firms via financial provisions provided by the government. The financial planning of subsidies should be carried out by the Ministry of Finance. The culture of business innovation can be rewarded in this way. In order to achieve this, a broad definition of innovation is most wanted.

*A statistical base for following-up effects of innovation policy measures and instruments should be set up.* Innovation policy requires tuning and adapting to the market. Setting up a statistical base for following-up effects of innovation policy measures and instruments is a necessity. It would enable assessment, monitoring and evaluation of innovation policy and innovation potential. Two frameworks may be used for that purpose. The first one is CIS, as a wide business survey that may be carried out bi-annually. The survey should encompass innovation activity of both SME and big firms, and should enable the evaluation of the effects of innovation policy measures on business innovation potential and output. The Ministry of Science, Education and Sport should be the body responsible for carrying out CIS. Additionally, in the light of the integration with the EU, EIS may be tracked as a system of indicators that allows the ranking of Croatia with the EU and Bulgaria and Romania each year. The Office for the Development Strategy of the Government could keep track of the data within the system of indicators and report on the progress to the Government and the public.

*Venture capital should be encouraged.* Attention must be devoted to venture capital development since venture capital is one of main

sources of finance in the world, and especially so for SME innovators. In Croatia, venture capital is still not presented in the form of a legislated entity but in business practice little of it exists. The Ministry of Finance should propose to Parliament that legislation be introduced concerning venture capital as a new type of business activity.

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- i *These changes are defined by the Strategy of Development of Science of the Republic of Croatia in the 21st Century ([www.hrvatska21.hr](http://www.hrvatska21.hr)) and the Act on Scientific Activity and Higher Education.*
  - ii *In the abbreviation AK, A symbolizes the constant that implies the existence of a linear relationship between the national product (Y) and capital (K).*
  - iii *The Diamond is made of four areas, each of which creates a setting for the prospering of certain industries. These four areas are: (1) factor conditions, (2) demand conditions, (3) related and supporting industries, and (4) firm strategy, structure and rivalry.*
  - iv *Ministry of Science, Education and Sports since 2004.*
  - v *Triple Helix means the transformation of science into economic good and promotes intensification of this process. The intensification of those processes increase reliance of industry on knowledge originated in academic institutions (Etzkowitz, 1998).*
  - vi *Knowledge creation in the post-industrial era is the result of individual or group innovation activity intra/inter firm.*
  - vii *European Patent Office is a result of unique initiative to establish uniform patent system in Europe, retrieved at [[http://www.european-patent-office.org/epo\\_general.html](http://www.european-patent-office.org/epo_general.html)].*
  - viii *The methodological basis of CIS is provided by the Oslo Manual – international source of guidelines for the collection and use of data on innovation activities in industry (OECD, 2003).*
  - ix *CIS analysis does not include several goods and services sections and subsections from National Classification of Economic Activities (NACE). Those are: Construction, Hotels and Restaurants, Real estate activities, Renting of machinery and equipment without operator and of personal and household goods.*
  - x *According to technological level economic activities are classified: High-technology (Aerospace, Computers, office machinery, Electronics-communications, Pharmaceuticals); Medium-high-technology (Scientific instruments, Motor vehicles, Electrical machinery, Chemicals, Other transport equipment, Non-electrical machinery); Medium-low-technology (Rubber and plastic products, Shipbuilding, Other manufacturing, Non-ferrous metals, Non-metallic mineral products, Fabricated metal products, Petroleum refining, Ferrous metals); Low-technology (Paper printing, Textile and clothing, Food, beverages, and tobacco, Wood and furniture).*
  - xi *Croatian CBS provides life-long learning data by carrying out Labour Force Survey twice a year. The value for the first half of 2003 was 34,865 and for the second half of the year 46,610. The nominator value for life-long learning indicator presents yearly average approximations.*
  - xii *EIS proposed four patent applications indicators: EPO applications, USPTO applications, EPO high-tech patent applications, USPTO high-tech patent applications. Since Croatia has only 2-3 EPO applications per year, it is unnecessary to evaluate other indicators.*

- xiii Data for Hungary, Romania and Bulgaria were not available.*
- xiv Data for Croatia refer to the period 2001-2003 and for the other CEEC countries to the period 1998-2000.*
- xv Innovation expenditure includes a full range of innovation activities: in-house R&D, extramural R&D, machinery and equipment linked to product and process innovation, spending to acquire patents and licenses, industrial design, training, and the marketing of innovations (European Commission, 2003a).*

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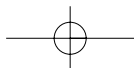
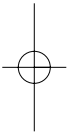
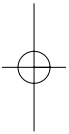
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## Chapter 7

# **EXTENDED SOCIAL EUROPE? SOCIAL POLICY, SOCIAL INCLUSION AND SOCIAL DIALOGUE IN CROATIA AND THE EUROPEAN UNION**

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## **ABSTRACT**

The paper discusses aspects of Croatian social policy, particularly social inclusion and social dialogue, in the context of Croatia's status as a candidate country for accession to the EU. It describes the development of a European Social Model demonstrating that, notwithstanding certain problems, significant achievements have been made within the EU. Social dialogue has evolved from consultation to social governance, and the open method of co-ordination is implemented not only regarding employment issues but also in the social inclusion process. Furthermore, European concerns have been extended to the fields of pensions and health care, which will be addressed in future joint EU Social Protection Reports. The paper notes the salience of social policy issues in previous waves of accession. Analysis of Croatian welfare reforms shows that, thus far, the EU impact has been

*\* The authors would like to thank the referees who anonymously reviewed this paper.*

very limited. The paper calls for strengthened efforts, by Croatia and the EU, to ensure that aspects of social policy and the European Social Model are more systematically discussed, addressed and implemented as Croatia proceeds towards EU membership.

**Key words:**

Social Europe, European Social Model, social policy, social protection, social inclusion, social dialogue, open method of co-ordination, accession, welfare reforms, Croatia, European Union

## INTRODUCTION

This chapter explores aspects of Croatian social policy, including the process of social dialogue, in the context of Croatia's status as a candidate country for accession to the EU. The concept of "extended social Europe" refers to two dimensions which have been much discussed by scholars and EU policy analysts. The first concerns whether, and in what ways, the EU has a deeper commitment to social issues than in the past. The second concerns the inter-relationship between the social concerns of the EU and the process of the enlargement of the EU.

Social inclusion and social dialogue have, thus far, been paid less scholarly attention in Croatia than other elements of European social policy questions, including employment policies, gender equality, and the development of civil society (Vasiljević, 2003; Vidačak, 2003). In addition, questions of social policy and social protection have tended to be reduced to narrow concerns with poverty alleviation (Bejaković, 2004).

Our argument here is that social policy concerns and social dialogue in Croatia have not been sufficiently developed or discussed in the context of EU accession. Greater efforts should be invested in the elaboration of the core principles of social dialogue and of social policy, in commitments to strengthening social dialogue and to promoting social inclusion, and to measures for implementing social dialogue and strengthening social protection systems. Without these efforts, Croatia risks being unprepared for the social dimensions of EU membership in the short- and medium-term.

In this chapter we focus, firstly, on the context of Social Europe and note shifts in the consideration of questions of social policy and social dialogue. This is followed by a consideration of social policy

processes in different waves of accession including in the new post-communist member states of Central and East European countries (CEEC) and in the candidate countries of Bulgaria and Romania. Section 4 focuses on the relationship between the EU and Croatia, in the context of the wider Stabilisation and Association process (SAP) for the countries of South and East Europe (SEE). Section 5 draws some conclusions and makes some broad recommendations.

**Key definitions**

In its widest sense, *social policy* is "... any policy developed at supranational, state, local or community level which is underpinned by a social vision of society and which, when operationalised, affects the rights or abilities of citizens to meet their livelihood needs" (ODA, 1995:26).

*Social Dialogue* according to the ILO, refers to "... all types of negotiation, consultation and information-sharing among representatives of governments, social partners or between social partners on issues of common interests relating to economic and social policy" (Infocus Programme on Social Dialogue, Labour Law and Labour Administration).

*Social Inclusion* may be defined as "...the process by which efforts are made to ensure that everyone, regardless of their experiences and circumstances, can achieve their potential in life. To achieve inclusion, income and employment are necessary but not sufficient. An inclusive society is also characterised by a striving for reduced inequality, a balance between individuals' rights and duties and increased social cohesion" (Centre for Economic & Social Inclusion, 2002).

*Social Protection* refers to "...the public actions taken in response to levels of vulnerability, risk and deprivation that are deemed socially unacceptable within a given polity or society" (Norton [et al.], 2001).

**SOCIAL EUROPE**

**A historical overview**

In its beginnings the idea of a united Europe was not at all a social, rather, a political and economic project. The political idea of a Europe free from dangerous conflicts was reinforced and strengthened

by the economic need to create a common European economic area as a space for the free movement of goods and workers. Insofar as there was a concern with the social dimension of a united Europe, it was basically residualist and corporatist (Hantrais, 1995; Falkner, 1998; Vaughan-Whitehead, 2003). Social policy questions, restricted largely to those of the workplace, were seen as resolvable through dialogue between workers' and employers' representatives at the level of the firm or, at most, the nation state.

These basic ideas began to be questioned in the 1980s, in the context of an increasing awareness of social problems and social issues throughout Europe; the accession of three relatively poor new members, Greece in 1981, and Spain and Portugal in 1986; and the increasing hegemony of left-of-centre ideas within the EU and, in particular, in the active presidency of Jacques Delors from 1985 onwards.

The increased salience of social policy in this period is shown by the centrality of social policy in key EU policy documents<sup>i</sup> that established a series of fundamental social rights of workers, with the Social Chapter proposing three major changes: an extension of the competence of the Community on social issues; the introduction of qualified majority voting in new areas, such as health and safety, working conditions, information and consultations, and equal opportunities; and a recognition and extension of the role and rights of the social partners (Vaughan-Whitehead, 2003:13).

The early 1990s saw, in a sense, the simultaneous development of two apparently divergent trends. Firstly, in the context of the global hegemony of neo-liberal ideas which sought significant reductions in "non-productive" state expenditures, and the emphasis on "radical" macro-economic policies to move out of widespread recession in Europe, the EU introduced the Maastricht economic criteria which appeared to establish the fundamental pre-conditions for a far-reaching reduction of social rights throughout the EU. Although the academic social policy literature showed the resilience of European welfare states, or, at least, difficulties in promoting and implementing welfare retrenchment measures (Pierson, 1994; Esping-Andersen, 1996), the pressure for a reduction of social protection expenditures and scope seemed quite strong.

On the other hand, work on a new phase of the building of Europe, through the Amsterdam Treaty, which came into force in 1999, stressed also the need for a continuation of efforts to build the social dimension of Europe, following the logic noted above. A concern with human capital in terms of the quality and nature of employment was the

most important development here, as expressed in the new Employment Chapter from the Amsterdam Treaty. The Amsterdam Treaty article 126 states that “Member States shall regard employment as a matter of common concern and shall co-ordinate their actions” (Wyatt, 2002).

The stronger European integration in the beginning of the 1990s contributed to a more integrative approach to the question of poverty and social exclusion. In the Council Recommendation from 1992 the EC recognized that social exclusion processes and risks of poverty had become prevalent and more diversified over the last ten years and that the member states should recognize the basic rights of a person to sufficient resources and social assistance to live in a manner compatible with human dignity (Ferrera, Matsaganis and Sacchi, 2002).

The Amsterdam Treaty introduced, for the first time, a mandate for action by the EU to combat social exclusion and promote inclusion: “This makes it possible to promote the inclusion of vulnerable groups beyond the scope of actions in the context of employment policy. This is based on the recognition that, while work remains the central means of participation in society for most people, directly or indirectly, as individuals and as families, there are many other ways in which people can be excluded from economic, civil and institutional society” (European Communities, 1999:9).

A new phase began with the statement at the Lisbon Council in 2000 where EU member states committed themselves to working towards a new strategic goal for the next decade to “become the most competitive and dynamic knowledge-based economy capable of sustainable economic growth with more and better jobs and greater social cohesion. Achieving this goal requires a strategy aimed at modernising the European social model, investing in people and combating social exclusion” (European Communities, 2000; Begg and Bergham, 2002). The new millennium, thus, sees for the first time the EU extending its concern with macro-economic and employment issues to the broader sphere of social policies. Moreover, the functionalist and residualist notion of social policies has been finally severed. The promotion of policies to combat social exclusion is now seen as a legitimate area of EU concern.

### **The open method of co-ordination in social policy**

The process of elaborating this concern is the Open Method of Co-ordination (OMC) which was first introduced regarding aspects of



employment strategy in the Amsterdam Treaty. The Lisbon Council saw the OMC as a “learning process for all”, opening a policy space between integrative regulation and mere communication and co-operation, designed to spread best practice, be a driver for change, and to produce convergence of vision and agreement on outcomes. The OMC moves the EU into the arena of “soft law” governance processes, respecting national diversity in the means of achieving outcomes and realising the vision. In this sense, the development of organised and reciprocal learning processes to cope with a rapidly changing world is at the heart of the OMC, but it goes beyond a permissive notion of this “by defining European-level guidelines and identifying common challenges” (de la Porte, Pochet and Room, 2001:293), even if the response to these challenges is, to an extent at least, the responsibility of member states.

The clearest statement of the role of the OMC in social policy is provided by Frank Vandenbroucke who, as Belgian Minister of Social Affairs at the time of the Belgian presidency of the EU in the second half of 2001, made a crucial contribution to the EU’s focus on social inclusion: “(The OMC) involves setting common objectives at European level, defining appropriate national policies to achieve the objectives, and reporting national policy developments and outcomes. The (OMC) ... is designed to help member states to develop their own policies, reflecting their individual national situations, to share their experience, and to review the outcomes in a transparent and comparable manner. ... What Europe needs is an exercise in ambition in the social policy area. ... But there is not a single best practice: there are different ways to reach excellence ... ” (Vandenbroucke, 2002:V-VI).

**The social inclusion regime of the European Union: the five key elements of the open method of coordination**

- *Common Objectives on poverty and social exclusion* which were agreed at the Nice Summit in December 2000 (Council of the EU, 2000) and were revised at the Employment, Social Policy, Health and Consumer Affairs Council in December 2002 (Council of the EU, 2002). The Objectives set out an agenda in which member states commit themselves to “take steps to make a decisive impact on the eradication of poverty” by 2010.
- *National Action Plans against poverty and social exclusion*, often known as National Action Plans on Social Inclusion (NAPs/incl). There are the main vehicles through which member states indicate

their response to the Common Objectives. The NAPs/incl follow a common outline and cover a two-year period. The 15 member states submitted their first NAPs/incl in June 2001 and their second in July 2003. The ten new member states submitted their first NAPs/incl in July 2004 covering the period to mid-2006<sup>ii</sup>.

- *Joint Memoranda on social inclusion*, also known as Joint Inclusion Memoranda (JIMs). These were a prelude to the NAPs/Incl process, outlining the situation and policy priorities regarding poverty and social exclusion in the accession countries prior to their membership. Ten such JIMs were signed by the Commission and the national authorities on 18 December 2003<sup>iii</sup>. The JIM process remains in place for all accession countries, so that the JIMs for Bulgaria and Romania will be signed later in 2004.
- *Joint Reports on social inclusion*, which represent the response of various EU bodies to the NAPs/Incl. The first such Report was submitted to the Laeken European Council in December 2001 and the second, more detailed, was adopted in March 2004<sup>iv</sup>. In addition the Commission staff produced in June 2004 a working paper on Social Inclusion in the New Member States, which is a consolidated synthesis response to the 10 JIMs but, also, takes the opportunity to highlight key issues in the further development of EU social inclusion policy as a whole<sup>v</sup>.
- *EU Indicators on social inclusion*. The Belgian Presidency of the EU, in the second half of 2001, initiated a process of constructing indicators for poverty and social exclusion. These are sometimes known as the Laeken indicators because they were initially approved at the European Council meeting in Laeken in December 2001 (Atkinson [et al.], 2002). The construction of indicators was agreed to encompass three levels: (1) 10 primary indicators on financial poverty and material deprivation, employment, health, and education; (2) secondary indicators, supporting the lead indicators and supplying greater detail or describing other dimensions of the problem of poverty and social inclusion and (3) indicators which member states themselves decide to include in their NAPs/Incl to help interpret level 1 and 2 indicators and/or highlight specificities in particular areas.

A far-reaching reform, meant to strengthen the social dimension of the Lisbon process and streamline the OMC in social protection, was signalled by the Commission in May 2003 (Commission of the European Communities, 2003a). Essentially, following similar work on

economic and employment policy, the Commission's report envisages consolidating work on social inclusion, pensions and health care under the notion of social protection, based on common objectives (by 2009), National Reports on Social Protection (from 2006) and Joint Social Protection Reports (from 2005). As early as 2005, the first joint report on Social Protection should be issued, with a special focus on social inclusion. From 2006 onwards, the report will be integrated. In the subsequent two years, member states should submit lighter reports, with comprehensive and forward-looking reports produced every three years. Interestingly, whilst welcoming most of these proposals, the Social Protection Committee (Council of the EU, 2003) has signalled its concern that the identity and achievements of the social inclusion and pensions strategies should be maintained. It also recommends referring to the process as that of Social Protection and Social Inclusion.

A number of critiques have been made regarding the process of OMC in relation to social exclusion. Some commentators have argued that a neo-liberal, non-interventionist model of capitalist development remains the hegemonic discourse and practice within the EU. In this sense, social policy is conceived, primarily, in productive terms, with particular emphasis on employment policies. Where other social policies are discussed, these tend to be viewed in terms of minimalist support for the most vulnerable, and are, in any case, governed by the subsidiarity principle so that member states remain largely free to pursue social policies of their own choosing, with little power given to the EU itself. These commentators see the OMC as a weak instrument in comparison with the tougher regulatory powers within the *acquis communautaire* (cf. *inter alia* Taylor-Gooby, 2003; Begg and Bergham, 2002; Ferrera, Matsaganis and Sacchi, 2002).

Others, whose views we share, have suggested that the EU is today much more involved in social policy issues than ever before, that these issues are discussed at the European level where an appropriate policy is formulated, and that they are part of the core of EU concerns. Since 2000 the spring European Council meetings each year have discussed the interrelationships between economic, employment and social policies; this means that social issues are placed high on the European agenda. Indeed, the use of the OMC is being extended as a means of EU governance to areas such as pensions and health, hence covering the wider social policy arena. Consequently, a number of influential commentators have begun to see the EU as a regional force countering globalization pressures, with no evidence of social dumping

or a race to the welfare bottom (Graziano, 2003; Alber and Standing, 2000; Vaughan-Whitehead, 2003).

## Social dialogue in the European Union

The Treaty of Rome (1957) established a partnership between the Commission and social partners (Hantrais, 1995; European Communities, 1999; Vaughan-Whitehead, 2003). This was amplified by the Val Duchesse process which established an intensive bipartite cross-industry social dialogue on a series of social issues, including the further economic and monetary integration of the EU and acceptance of *The Charter of Fundamental Social Rights of Workers* (1989). In the course of preparation of the new Treaty in 1991 the social partners agreed about their new role, even extending to legislative oversight, but this agreement was not incorporated into the Maastricht Treaty as a result of the UK objection. Rather, it was adopted as a separate Social Protocol with binding force on eleven of the then twelve member states. Some years later, it was incorporated into the Amsterdam Treaty which became effective in 1999. The Treaty gives the social partners the right to be consulted on a series of social and economic issues, and gives them a legislative and regulatory role in the application of certain EU directives.

In the context of agreements on a range of issues such as parental leave; part-time and fixed-term employment contracts; work councils; and working time, social dialogue has developed from consultation to social governance. Today, it is impossible to envisage policy processes being implemented in any parts of the EU without the serious involvement of the social partners. Social dialogue is seen as a key force for innovation and change (Commission of the European Communities, 2002a). More broadly, social dialogue is increasingly seen as a part of a comprehensive civil dialogue, which involves different civil society actors, such as associations, foundations, non-profit institutions, and civil initiatives.

In order to commit itself to a new way of dealing with public issues the Commission issued recently two important documents: *The White Paper on European Governance* and *Towards a reinforced culture of consultation and dialogue* (Commission of the European Communities, 2002b). These reinforce the idea that social dialogue and extensive consultation are interconnected and that minimal standards are prescribed for the consultation process (cf. Zrinščak, 2004).

Essentially, the Commission is now committed to publishing all open public consultations through a single access point on the Internet.

## **SOCIAL POLICY REFORMS AND EUROPEAN UNION ENLARGEMENT**

The fall of the Berlin Wall represented a new historical moment for Europe. It quickly became clear, however, that the building of a democratic political society with a fully functioning market economy was not going to be without social consequences. In the field of social policy, capitalist-democratic Europe's existing three (liberal, social-democratic, conservative-corporatist) or four (South-European) major social policy models (Esping-Andersen, 1990; Ferrera, 1996), could not be simply applied to post-communist experiences, given their historical and cultural specificities. In addition, of course, the 1990s were not only the years of post-communist transition, but also the years in which trends of globalization, economic pressures, rising unemployment and inequality, and unfavourable demographic patterns limited the space for the construction of "new" welfare states.

The increased range of supra-state actors influencing social policy also made any notion of welfare regime models problematic, since social reforms were influenced, in varying ways, by the mix of international actors, including the EU, the OECD, the WTO, the Council of Europe, the ILO, and, often crucially, the World Bank and the IMF (cf. Deacon, Hulse and Stubbs, 1997).

Looking back, it is clear that the formal influence of the EU on accession states and new members has always been somewhat limited. For the first group of countries, the post-authoritarian states of Portugal, Spain and Greece, the most significant factor was their own orientation to become more "European" in all aspects of social life (Guillén and Matsaganis, 2000). This pointed to what has now been termed "cognitive Europeanization", or "the incorporation of the EU discourse on the fight against poverty and social exclusion, gender equality, conciliation of family and working life, and active employment policies into ... national ... discourse, preferences and aspirations" (Guillén and Álvarez, 2004:298). On becoming members, they posed significant questions about the speedy resolution of significant social problems, such as high poverty rates, lack of social services, the poor position of women in the labour market, and so on.

For the second group, the wave of post-communist accession countries, the EU's direct influence on the contents and overall structure or model of policy has been limited, and certainly low key, whereas the influence on the enhancement of institutional capabilities has been much more intense and meaningful (Guillén and Palier, 2004:206). The Hungarian social policy scholar Zsuzsa Ferge has argued, persuasively, that the EU was largely silent in the face of neo-liberal social policy reforms that certainly appeared to be some distance away from the European social model (Ferge, 2000). The social *acquis* is, therefore, for this group, much less important than the wider project that "transforms perceptions, identities, policy substance and policy formation, institutional structures, discourse and most of all policy meanings" (Lendvai, 2004:330).

The third case is that of Bulgaria and Romania where, throughout the process of negotiations, social issues, including the extremely high numbers of children in institutions, as well as the issues of street children, people with disabilities, people suffering from mental health problems, juvenile justice, minority (especially Romany) rights, international adoption, and social dialogue, have been high on the EU agenda. Whilst none of these concerns were sufficient, in themselves, to defer the membership of Bulgaria or Romania in the EU, they certainly contributed to the decision, taken at the European Council meeting in December 2002, following the Commission's recommendation in October 2002, to conclude negotiations with ten candidate countries but not with Bulgaria and Romania. Crucially, the severity of the problems, combined with high visibility and successful lobbying by a range of organisations, including international NGOs, succeeded in raising the issues from chapter 13 of the *acquis* to more crucial questions of human rights and political freedoms.

## **CROATIAN SOCIAL POLICY AND THE PATH TO EUROPEAN UNION MEMBERSHIP**

### **The Stabilisation and Association Process**

"The EU is ultimately a union of values. The governments of the region must, and are also increasingly seen to, espouse these values – values related to democracy, the rule of law, respect for human rights,

protection of minorities and a market economy. ... Values do not change overnight, however, and we have to give the countries the time they need – and appreciate that the SAP will not be a quick-fix but it is a long-term policy which will bring about sustainable results” (Commission of the European Communities, 2003b).

This quote very accurately describes the scope and even limits of the Stabilization and Association Agreement (SAA) signed between Croatia and the EU in 2001. It was very important, but only the first step in a long-term transformation process. Therefore, it focuses primarily on the political and economic aspects of changes. In EU reports on Croatia’s progress in 2002 and 2003 only four social policy issues were mentioned, and then only briefly (\*\*\*, 2002; 2003). In the first Report in 2002, some problems in civil society development were elaborated, and the view was expressed that co-operation between the Government and the trade unions could be better. In the second Report in 2003 the problem of the reduced financial support to civil society organisations was addressed. In addition, the fact that Croatia had ratified the European Social Charter with its three additional Protocols in February 2003 was mentioned. The statement was also made that in 2001 Croatia, with the help of the World Bank, had completed the institutional framework for financially sustainable pension system reform.

These remarks were in accordance with the fact that the SAA itself was silent on social policy issues. Only one article covers “co-operation in the field of social policy” and it stipulates (\*\*\*, 2002):

- improvements in services of unemployment, promotion of local development and help in restructuring the industrial market and the labour market;
- adjustments of social security systems to new economic and social requirements;
- adjustments of the legal system in respect of work conditions and equal opportunities for women and men;
- improvements in the protection of health and security of workers.

Notwithstanding its vagueness and level of generality, the SAA, together with the new reform-minded public climate, did provide a space for some new questions entering the public agenda, such as gender equality, family violence, and children’s rights. The decentralisation process, initiated in 2001, again notwithstanding its many problems, also opened a space for a range of non-state actors to be involved

in provision, advocacy and, to a very limited extent, policy dialogue in social protection. Beyond this, any broader influence of the EU in the field of social policy reforms is very hard to trace. As mentioned, in 2001 the Government completed the pension reform shaped in previous years and strongly influenced by World Bank ideas, with the EU very much a silent bystander.

### **Welfare reforms in Croatia**

At the same time, because of financial restraints and, in particular, IMF requirements, the Government reduced some social payments, particularly in the field of family policy. In 2002, the Government adopted a “Programme for Combating Poverty and Social Exclusion”. The importance of this document should not be underestimated. For the first time, an official document addressed the question of poverty and social exclusion and outlined the role and tasks of different state agencies in reducing the poverty rate. However, several weaknesses of this document must be noted. The document was entirely drafted and adopted by state representatives with the support of some social policy experts and professionals. No social partner or civil society representatives were included in the drafting process and there was no wider consultation process. The document remained merely declaratory in nature, in part because of a lack of evidence and data – by this time, still only one very limited and dated piece of research on poverty existed, the World Bank study published in 2000, based on a household survey from 1998 (World Bank, 2000). The report appears not to have been written with the process of EU accession in central place – the process of the SAA and the wider Copenhagen criteria are noted only briefly. Therefore, the social inclusion process which was already underway inside the EU at this time, and which is noted above, did not influence the Programme in any way. Crucially, the EU Laeken indicators were neither noted nor utilised. The Programme concludes by stating that a tripartite body for inspection would be established and that it would report once a year to the Government about results and possible changes. Such a body was, apparently, established but no report has yet come to the Government, much less been discussed in public or with the social partners.

The momentum and direction of reform has come from elsewhere and has not, in any sense, borne the marks of EU influence. The



social welfare reform project, led by the then Ministry of Labour and Social Welfare, began in April 2002, with the first phase, lasting a year, financed by the World Bank, the UK's Department for International Development (DFID) and the Government of Japan. In addition to work on the reform of social services, social assistance, and labour market policies, one part of the project was devoted to the problem of monitoring poverty and, in particular, strengthening the institutional capacities for measuring poverty. Very specific recommendations were developed and, in 2004, the Croatian Bureau of Statistics for the first time issued data on poverty which included some, although by no means all, the Laeken indicators.<sup>vi</sup> The future of the entire reform project, based on a World Bank loan, remains unclear, including the development of data on poverty and social exclusion.

## Social dialogue

Prospects for social dialogue were also partly improved after the election of the new Government in January 2000 although, again, without significant EU influence or involvement. In 1999 the biggest trade union federation, the SSSH (Savez samostalnih sindikata Hrvatske) signed an Agreement for a Legal Croatia with the then six opposition parties (Cimeša and Marinković Drača, 2002; Cvitković, 2003). This contributed to the victory of the six in the elections in 2000, and led to high expectations of a change in the relationship between the Government and the trade unions. Subsequently, the institutional framework for social dialogue was improved through three events: the adoption of the Agreement about the Economic-Social Council and other forms of social partnerships; the adoption of the agreement "Partnership for Development", signed by the Government, the employers federation (HUP) and four trade unions; and the establishment of the Office for Social Partnership in Croatia. The latter, in particular, received substantial support, both financial and technical, from USAID.

Changing the institutional framework does not in itself guarantee changed practices, of course. The trade unions quickly abandoned their pre-election Agreement and became vocal opponents of aspects of Government policy. In addition, at the micro-level, different analyses have shown that at the level of industrial sectors or of individual companies, partnership between employers and trade unions is almost non-existent (Zrinščak, 2005). In this sense, the recent EU conclusion, in the

*avis*, that social dialogue is “quite developed“ in Croatia does not appear to be justified. In this respect the Croatian situation is very similar to that found in other post-communist countries: “The annual reports on the achievements of the *acquis* concentrated on the existence of the legal grounds of social dialogue. They rarely produced a critical assessment on the implementation of the legislation. ... Lacking the obligatory nature of rules governing this field, the efforts of EU agents proved insufficient to overcome the impediments to establishing effective social dialogue” (Ferge and Juhász, 2004:238). Unlike Hungary, however, where there was a degree of EU financial support for social dialogue, the strong role of USAID in Croatia has, at least implicitly, tended to push policy transfer in the sphere of social dialogue based on the somewhat different US experience.

### Social policy and the CARDS programme

To support the SAP, the EU makes available considerable project-based funding. In March 1995, a decision was made to include Croatia in the PHARE programme of assistance. However, before this began in earnest, the decision was revoked following Croatian military actions in August 1995. EU financial support for Croatia was then limited, with Croatia receiving only a total of 33 million euros in 1999 and 2000, mainly for projects promoting refugee return.

Under a European Council decision of 5 December 2000, a new programme of financial support to the countries of the Western Balkans as well as a regional programme was introduced. The CARDS Programme was envisaged as running from 2000-2006, within an overall financial envelope of 4.65 billion euros. Under the programme, Croatia received 60 million euros of assistance in 2001, 59 million euros in 2002 and 62 million euros in 2003, some 9.4% of total allocations<sup>vii</sup>. In the light of the positive *avis*, Croatia’s 2004 allocation has been revised to 76 million euros, covering five priority areas: Democratic Stabilisation (17.5 million euros); Economic and Social Development (17.75 million euros); Justice and Home Affairs (21.85 million euros); Administrative Capacity Building (15.1 million euros); and Environment and Natural Resources (3.8 million euros) (Delegation of the European Commission to the Republic of Croatia, 2004).

Within the CARDS programme as a whole, very limited attention has been paid to issues of social inclusion or social dialogue, for

any of the countries individually or in terms of the regional programme (Stubbs, 2004). Whilst it could be argued that, implicitly at least, social dimensions are important within the CARDS programme support for the revitalisation of Croatia's war-affected areas, it is significant that social policy concerns are singularly absent from 2004's social development priorities (which focus on adult learning, training for the unemployed, and university co-operation) and from administrative capacity building (focusing on public finances, regional development, and telecommunications).

Currently, the only CARDS-funded initiative with an explicit social policy focus in Croatia is the ongoing support for capacity building and grants to NGOs involved in the social sector, through the newly established Foundation for Civil Society Development. The project is likely to have some impact in terms of promoting a "welfare mix", but it is of relatively small size, and still mainly focused on war-affected areas. In addition, it makes too few connections with any broader process of building strategies or promoting social dialogue in the field of social inclusion.

Currently, in the context of the regional programme, the European Commission has a consultancy which is designed to increase the responsiveness of the CARDS programme to social policy concerns, particularly in relation to administrative capacities. However, in view of the time lags and inevitable delays involved in EU programming, this seems unlikely to be a catalyst for greater alignment of Croatia with EU work on social inclusion in the foreseeable future.

It is interesting to compare the CARDS programme with PHARE which was also seen as having a limited social policy dimension (de la Porte and Deacon, 2002:29). Two of the three factors which are said to account for this, that TORs were written by experts with little understanding of "the political context and priorities of the recipient countries", and "poor project design and selection of inappropriate experts for implementing the projects" (ibid:28), still remain the case, relating to wider concerns with the EU's sub-contracting regime. In theory, the third concern, that inputs, or actually getting a project done, are seen as more important than the project's "long-term relevance and sustainability" should have been partly offset by the introduction of strategically focused multi-annual programming and a strengthening of in-country management capacity. However, whilst this has occurred in areas such as regional development and civil society strengthening in Croatia, it is far from the case regarding social policy, social inclusion, and social dialogue.

In addition, the failings of the PHARE programme in regard to social policy were explicitly recognised in rationale for the launch, in 1995, of the CONSENSUS programme which, for all its faults, many of which also related to sub-contracting and choice of experts, did serve to advance the external dimension of EU social policy and facilitate a dialogue between member states' and accession countries' welfare ministries and officials of the Directorate General for Employment and Social Affairs (ibid:31). The goals of CONSENSUS were to assess the state of accession country social policy, to promote a dialogue concerning social protection and social policy, as well as signalling priority areas for further work in the future. It thus represents a precursor to the OMC. The demise of CONSENSUS in 1999 can itself be seen as "indicative of a lack of consistent external policy thinking on the part of the Commission" (ibid:42), and leaves the CARDS programme without any similar counterweight in terms of social issues.

### **The avis and the European partnership agreement**

The opinion or *avis* regarding Croatia's application for EU membership, issued by the Commission in April 2004, states that social dialogue is "quite developed" in Croatia although it also suggests that "efforts towards the creation of an autonomous bi-partisan dialogue, especially at branch level, should be strengthened" (Commission of the European Communities, 2004a:86). In contrast to Romania and Bulgaria, there is an absence of discussion of social issues within broader political criteria. In terms of social protection, the report calls the system "generous" when compared to the size of the economy (ibid:88). Echoing the point about data made above, although not explicitly referring to the Laeken indicators, the *avis* states clearly: "An area where further progress is needed is the introduction of internationally comparable qualitative and quantitative indicators of social exclusion and poverty, as well as methods for its calculation..." (ibid:88) with more analysis needed of the issue particularly in relation to future policies for vulnerable groups and the war-affected areas. Overall, the *avis* suggests that "considerable and sustained efforts" will be needed to align legislation with the social *acquis* and effectively to implement the provisions in the medium term. In addition, Croatia needs to prepare itself for communication processes at the EU level on employment, social inclusion and pensions.

In the light of this, it is perhaps surprising that the EU Partnership Agreement with Croatia, issued at the same time as the *avis*, is virtually silent on social policy issues. The document sets out the priority areas for Croatia's preparation for further integration with the EU based on the *avis*, in terms of short-term (1 to 2 years) and medium-term (3 to 4 year) priorities. There are no social issues listed in the short-term priorities. In the medium-term, there is a concern with alignment of social and economic policies with EU law, and the importance of administrative regulations for the co-ordination of social security. In addition, the document calls on Croatia "further to develop the capacity of the social partners, notably in bipartite social dialogue, to develop and implement the *acquis*" (Commission of the European Communities, 2004b:13). There is no mention in the document of issues of social inclusion or of the importance of aligning Croatian statistics and procedures with those of the EU, regarding poverty and social exclusion or social protection as a whole.

## CONCLUSIONS AND RECOMMENDATIONS

The European Social Model has been intensively developed amongst member states in the 1990s and has been further developed in the new millennium. A more active role for the EU in social policy and social protection, based on the OMC, is now at the heart of Social Europe. With the exception of Bulgaria and Romania, this has not, thus far, been an important element of the pre-accession process for aspiring new member states. It was only in the latter stages of the accession process, with completion of the Joint Inclusion Memoranda, that the eight post-communist countries who joined the EU in May 2004, first encountered these processes in earnest. However, because of the latest development of the European Social Model, it may well be that Croatia will encounter more demands during the pre-accession phase.

As it stands at the moment, social protection and social dialogue are not priority areas in the EU's relation with Croatia. This is in part, perhaps, because other issues, many of which include a social component, of course, such as the questions of regional and local development in the context of geographical inequalities, the development of the war-affected areas, refugee return, minority rights, and the workings of the legal system, are seen as far more pressing problems. It is also, perhaps, because, in terms of the scale of social problems, Croatia appears to

resemble the eight countries of Central Europe rather more than it does Bulgaria and Romania. Still, the *avis* regarding Croatia's application for EU membership asks, as we noted, for considerable and sustained efforts to align Croatian legislation with the social *acquis* and, moreover, to effectively implement it.

This chapter has, therefore, demonstrated that there is no cause for complacency in Croatia. Above all, in the context of the EU's concern not only with alignment of legislation but, also, of implementation and the development of excellence, Croatia's lack of strategic direction in the social sphere, the lack of leadership, as well as a lack of broader consultation and public awareness, are major deficits in the path towards European integration. In addition, the lack of a statistical base for work on social inclusion suggests a high degree of unpreparedness for what will, by 2007, be a strengthened and more holistic EU approach to social policy within its member states.

In the context of possible revisions to the CARDS programme, the EU needs to take a much more proactive role in debates and in programmes regarding social policy and social dialogue in Croatia. The profiles and assumptions of external agencies such as the IMF, the World Bank and USAID are too dominant in Croatia, and the need for an active EU engagement is necessary in the short- and medium-term.

In addition, the Government needs to begin now to prepare for the obligations of membership in terms of the broad sphere of social protection. This should start with the elaboration of statistics, data bases, and indicators for social exclusion, as well as for pensions and health, based on the EU indicators. Beyond this, processes of consultation regarding Croatia's obligations in this sphere and the strengthening of the role of social partners including trade unions and civil society organisations need to begin now. Greater public awareness of issues of social inclusion and of social dialogue needs to be fostered.

The mechanisms for social dialogue need to be improved at national, regional and at sectoral and firm levels. Importance should be placed not only on what is happening in the field of consultations with social partners at the national level, but also at other levels. It has been confirmed that trade workers' representatives are largely marginalized at sectoral and firm levels. More than this, the climate for social dialogue needs to be considered. If social partners cannot undertake their roles inside an effective consultation process, the path towards the new governing process (inside which they are legislators who decide about implementations of certain decisions) will not be possible at all. This

also relates to civil society organisations as the social and civil dialogues are considered parts of the same process.

In fulfilling many of its international obligations on questions of social policy, most recently in terms of the Millennium Development Goals, Croatia tends to be minimalist in its production of reports, which resemble internal governmental or expert documents, rarely conceived as a part of a wider process of awareness-raising and of consultation with stakeholders. The lack of strategic direction in social policy, the failure to resolve key issues such as the role of the state through Centres for Social Welfare and the role of non-state actors, both in civil society and in the private sector, and the absence of decentralised, meaningful social planning mechanisms are key weaknesses in current policy. In addition, there appears to be little or no discussion of the importance of community-based provision over and above institutional care. There are also no short-, medium- or longer-term outcome indicators for future social protection in Croatia. The co-ordination of different policies, including recently developed family policy, is also not well developed.

In short, Croatia on the path to EU membership faces a number of so far largely hidden deficits in the field of social policy and social dialogue. In the context of the EU's increasing emphasis on actual implementation and changes in practices on the ground, over and above legislative changes, these deficits could be treated as more significant by the EU in the future for new candidate countries, including Croatia. Unless they are remedied quickly, EU accession will simply render these deficits visible and show the distance still needing to be travelled to embrace the emerging European social model, promote high standards in social policy and social dialogue, and demonstrate a degree of strategic vision not seen in the recent past.

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- i *These included The Charter of Fundamental Rights of Workers (1989), The Social Policy Agreement (1991) also known as The Social Protocol or The Social Chapter, The White Paper on European Social Policy (1994) and The Resolution on EU Social Policy (1994).*
  - ii *Full texts of all NAPs/Incl can be found at: [[http://europa.eu.int/comm/employment\\_social/news/2001/jun/napsincl2001\\_en.html](http://europa.eu.int/comm/employment_social/news/2001/jun/napsincl2001_en.html)].*
  - iii *Full text versions of the JIMs can be found at: [[http://europa.eu.int/comm/employment\\_social/soc-prot/soc-incl/jim\\_en.html](http://europa.eu.int/comm/employment_social/soc-prot/soc-incl/jim_en.html)].*
  - iv *The two reports are available at: [[http://europa.eu.int/comm/employment\\_social/soc-prot/soc-incl/joint\\_rep\\_en.htm](http://europa.eu.int/comm/employment_social/soc-prot/soc-incl/joint_rep_en.htm)] (accessed 30 August 2004).*
  - v *The report is available at the JIMs web site (endnote iii above).*
  - vi *See: [www.dzs.hr](http://www.dzs.hr).*
  - vii *Source: [[http://europa.eu.int/comm/europeaid/projects/cards/financial\\_en.htm](http://europa.eu.int/comm/europeaid/projects/cards/financial_en.htm)].*

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## Chapter 8

# **FREE MOVEMENT OF CAPITAL, THE REAL ESTATE MARKET AND TOURISM: A BLESSING OR A CURSE FOR CROATIA ON ITS WAY TO THE EUROPEAN UNION?**

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### **ABSTRACT**

This paper investigates how one particular aspect of the freedom of movement of capital – the right of EU residents to acquire real estate in EU member states – might shape Croatia's EU accession negotiations and affect its real estate market, the tourism industry and the national economy. It identifies potential benefits and risks of unrestricted foreign investment in Croatian real estate, and attendant dilemmas for economic policies. The main conclusion is that Croatia stands to benefit in the long run from foreign investment in the property sector. However, a gradual approach to the opening-up of the real estate market to non-residents can be justified on a number of grounds. These include inadequate legislation limiting property speculation; potential spillovers of price increases from the market for secondary residences

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onto the local housing market (of which there is already some evidence); costs of the adjustment in the housing market and construction industry to a sudden large increase in demand for secondary residences; loss of competitiveness in the tourism industry if there should be violations of building regulations and the resulting overdevelopment of coastal areas; and macroeconomic pressures arising from large and sudden capital inflows.

**Key words:**

Croatian economy, European Union accession negotiations, new member states, free movement of capital, real estate market, housing prices, housing finance, secondary residences, travel and tourism, protection of public coastal domains, local government, capital inflows

## INTRODUCTION

Since Croatia became an official EU candidate in June 2004, public discussions on the benefits and costs of accession have intensified in many areas. This paper addresses four issues that have attracted particular attention: How quickly should EU residents get unrestricted access to Croatia's property market? How will this affect – or is this already affecting – the local housing market? What will be the impact on Croatia's tourism? And what are the likely macroeconomic effects of foreign investment inflows into Croatia's real estate? As is often the case, serious research has yet to catch up with the enormous public interest in these issues. This paper is therefore a first attempt to analyse the issues in a systematic manner and provide guidance for future work in this area. The main purpose is to stimulate analysis and policy thinking on these important issues ahead of the upcoming accession negotiations with the EU.

Section 2 analyses Croatia's obligations under Chapter 4 of the *acquis*, Freedom of movement of capital, paying particular attention to the right of EU residents to invest in real estate in candidate countries, and discusses Croatia's current regime for property sales to foreigners. The current regime is rather restrictive, non-transparent and cumbersome in some respects, but relatively liberal in others. However, a more important issue is that this regime will eventually have to be abandoned, thus exposing the economy to potentially large-scale foreign property investments. For under EU law, EU citizens have unrestricted

rights to buy as much property as they like in any EU country without any need to reside in that country. This means that non-residents will not be restricted to buying only secondary residences as at present, but will also be able to buy property for speculative purposes, against which there is currently only weak protection in the Croatian legislation. Against this background, Section 2 investigates how Croatia can improve its negotiating position on this issue. Drawing on the experience of Denmark and Malta, the section highlights the importance of the expertise and negotiating skills of officials engaged in accession talks with the EU. It notes, however, the difficulty of articulating the view that EU residents should not be allowed to acquire property in Croatia for an extended period of time, and the importance of strengthening legislation to protect against property speculation.

Section 3 analyses potential implications of foreign investment in real estate for the local housing market. It discusses the main characteristics of Croatia's real estate market and reviews recent developments in housing prices. It finds some empirical evidence that increased demand for secondary residences by foreigners has led to an increase in prices of houses and land for construction on the Adriatic. It also analyses factors that might determine the effects of foreign property investment on the housing market in the future. These effects will depend on the speed with which the property market is liberalised; capacity constraints and competition in the construction industry; the speed with which legal impediments to property sales are removed; and developments in household incomes, housing finance and other factors influencing the affordability of housing. Given the likely supply rigidities, the section argues that a gradual approach to the opening of the real estate market to non-residents would allow for a more orderly adjustment than a rapid removal of restrictions.

Section 4 considers how increased foreign investment in real estate could influence Croatia's tourism industry. To provide insights into this question, the section analyses the size and main features of Croatia's tourism industry. The question that seems particularly relevant in this context is whether accession to the EU offers the opportunity for tourism to assume a leading role in overall economic development, or represents a threat to one of its main assets, the unspoilt coastal environment. On balance, Croatian tourism stands to benefit from foreign property investment. The key will be to avoid the risk of overdevelopment, that is, to ensure strict enforcement of existing building regulations and of the recently adopted legislation on the protection on the

public coastal domain. Greater foreign ownership of secondary residences could increase the attractiveness of the Adriatic coast and islands for other tourists and over the longer term perhaps contribute to the economic and demographic revival of many now dormant or abandoned communities.

Section 5 analyses diverse macroeconomic effects that increased foreign investment in real estate would have for the Croatian economy. The wealth effect has already been in evidence for some time, as the value of houses and land in areas that are attracting foreign buyers has increased considerably over the past few years. Due to potentially large capital inflows associated with non-resident real estate purchases, the section elaborates several arguments for a gradual opening-up of the market.

Section 6 summarises the main conclusions and elaborates a number of policy recommendations.

## FREE MOVEMENT OF CAPITAL

The EU internal market is based on the principle of the “four freedoms” of movement: of goods, services, capital and people. As a general rule, the EU is not willing to accept candidate countries' requests to limit these freedoms because this could have a significant impact on competition and the functioning of the internal market. Croatia – as all EU candidates before it – will thus have to allow basically unrestricted movement of goods, services, capital and people by the time it accedes to the EU. The Treaty Establishing the European Community (Article 56) prohibits in particular all restrictions on movement of capital between member states but also between the member states and third countries, although certain restrictions in relation to countries outside the EU can be retained.

Freedom of movement of capital is defined in Chapter 4 of the *acquis communautaire*. It covers not only payments and transfers of money across borders, but also transfers of ownership of assets and liabilities (such as investments in companies and real estate or portfolio investments) and directives on prevention of money laundering. This paper discusses only one type of capital movement – the right of EU residents to purchase real estate in Croatia. Croatia's obligations in this regard are currently defined in the Stabilization and Association Agreement (SAA), (Article 60, point 2):

“As from the entry into force of this Agreement, Croatia shall authorise, by making full and expedient use of its existing procedures, the acquisition of real estate in Croatia by nationals of Member States of the European Union, except for areas and matters listed in Annex VII.<sup>i</sup> Within four years from the entry into force of this Agreement, Croatia shall progressively adjust its legislation concerning the acquisition of real estate in Croatia by nationals of the Member States of the European Union to ensure the same treatment as compared to Croatian nationals. At the end of the fourth year after the entry into force of this Agreement, the Stabilisation and Association Council shall examine the modalities for extending these rights to the areas and matters listed in Annex VII.”

By the time Croatia joins the EU, the SAA will be superseded by an Accession Treaty. Although the Treaty will be largely based on the SAA, it may treat a number of issues differently. The whole purpose of accession negotiations is precisely to agree under what conditions Croatia will accept, apply and administratively and legally implement different chapters of the *acquis*. Commitments under the SAA regarding non-residents' right to purchase property in Croatia thus can and, as argued in this paper, probably should be re-negotiated in the process of Croatia's accession to the EU.

What is the current situation regarding the acquisition of real estate in Croatia by non-residents? Private non-resident individuals can already become owners of real estate in Croatia (other than by inheritance) after obtaining permission from the Ministry of Foreign Affairs. They are restricted to one property, which is limited in size (the construction site cannot exceed 1,500 m<sup>2</sup>), and there are areas in which they may not acquire property, such as protected natural areas, agricultural land, forests and forest land and certain excluded areas.<sup>ii</sup> Key issues in the application procedure, which can reportedly take up to a year, are the approval of the transaction by the Ministry of Justice and the existence of a reciprocity agreement on real estate purchases between Croatia and a given non-resident's home country.<sup>iii</sup> For instance, US residents may be granted permission to buy property in Croatia because Croatian citizens can acquire property in the United States without restriction. In contrast, private individuals from Slovenia cannot acquire property in Croatia because Slovenia and Croatia do not have a reciprocity agreement in this area.<sup>iv</sup>

According to the official data quoted by the news media, 3,200 foreign residents have obtained permission to buy real estate in Croatia



since 1996, when the property market was first opened to foreigners (Table 1).<sup>v</sup> Less than 40% of applications have since been approved, 7% have been rejected, and over half have not yet been processed.<sup>vi</sup> The number of applications has varied from around 550 per year during 1996-99, to around 1,250 per year since 2000.

In addition to private non-resident individuals, non-residents who set up a Croatian company can also acquire property in Croatia. In this case there is no need for government permission to buy the property (although there are various other legal and financial considerations) and the buyer is not restricted to one piece of property. There is no official information on the number of companies set up for this purpose. However, since establishing a company normally takes much less than one year and is not costly, there are indications that many foreigners (in particular from countries such as Slovenia that do not have reciprocity agreements) make use of this alternative to acquire real estate in Croatia.<sup>vii</sup>

*Table 1 Non-resident applications to buy real estate in Croatia, 1996-2004*

	No. of applications	Approved	Not approved	In process
2004 (Jan-Sep) <sup>1</sup>	1,050	22	10	1,018
2000-04	6,257	2,381	445	3,431
1996-99	2,192	921	128	1,143
Total 1996-2004	8,449	3,202	573	4,574
Percent of total, 1996-2004	–	38.1	7.1	54.8

<sup>1</sup> *New applications only. In addition, 242 applications from previous years were approved and 46 rejected in the first nine months of 2004.*

*Sources: Ministry of Foreign Affairs, quoted in Jutarnji list (21 October 2004) and Vjesnik (26 October 2004); author's calculations*

The existing regime for property sales to foreigners can thus be characterised as relatively restrictive, non-transparent and cumbersome in some respects, but relatively liberal in others. In particular, it is not clear why the processing of applications takes so long and why the criteria used in evaluating the applications are not transparent and public. On the other hand, it is important to recognise that current arrangements with respect to the sale of property to third country residents are already more liberal than the EU legislation requires: not just EU nationals, but residents of any country where Croatian citizens have the right to acquire property can in principle become owners of real estate in Croatia. Moreover, residents of virtually any country can buy property if they register a Croatian company.

How will these arrangements change with implementation of the SAA and Croatia's accession to the EU? The main change is that, upon expiration of the four-year transitional period agreed in the SAA (or perhaps a longer period yet to be negotiated during accession talks), EU residents will have the right to buy real estate in Croatia without any restriction. This means that they will not be restricted to buying only secondary residences or just one piece of property, and will not be subject to other conditions, such as prior approval, size, or use of the property. Under EU law, EU citizens have full rights to buy as much property as they like in any EU country without any need to reside in that country. This means that non-residents can also buy property for speculative purposes, unless this is limited by domestic legislation, which is largely not the case in Croatia at present.

It is not clear whether these implications of EU accession are clear to the Croatian public and to policy makers. In any case, they have not yet been articulated in public discussion. The real issue is that the existing restrictions on real estate sales to foreigners, however imperfect, will eventually have to be lifted, thus exposing the economy to foreign property investments of potentially far greater magnitude than anything that has been observed so far. This raises the question of whether the authorities could or should do something to keep the existing restrictions in place for more than four years, and how to better protect in the meantime against property speculation.<sup>viii</sup>

At present, commercially motivated property sales in the secondary market are subject to income tax only if the sale occurs within three years from the purchase of the property. Part of the capital gains from such sales is not taxed.<sup>ix</sup> There seem to be no additional regulations preventing speculation in the market for land or uncompleted property. For instance, an entrepreneur could buy up large swathes of land for construction, or batches of uncompleted apartments and houses, in the expectation that prices will rise rapidly due to limited supply, and then resell at a higher price. While the entrepreneur would pay the regular profits tax, the tax authorities would not be in a position, as in most mature market economies, to make a judgement about the fair value of such transactions, and, hence, any extra profits earned by the entrepreneur due to speculative activity. The lack of capital largely prevents Croatian citizens from engaging in such activities at the moment, so the weakness of anti-speculative regulations may not be obvious. But once the property market is opened up to non-residents, the lack of capital will no longer con-

strain this type of activities, and the weakness of the legislation could manifest itself very quickly, resulting in the meantime in potentially large disruptions in local property markets. The remainder of this section considers only the first issue – whether the authorities could or should do something to keep in place the existing restrictions on property sales to non-residents. The issue of anti-speculative legislation requires a separate expert analysis that goes beyond the scope of the present paper.

How have other candidate countries handled the issue of transitional periods for real estate purchases in their accession negotiations? The biggest issue in most cases turned out to be the right to purchase land. Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia requested 10-18 year moratoria on the sales of land to EU residents (Table 2). They justified the need for moratoria by several social and economic factors, including the high share of the population working in agriculture; underdeveloped land markets; significantly lower land prices in candidate countries than in the EU-15; and substantially lower average income of domestic population relative to EU nationals, which would give EU nationals an unfair advantage in purchasing agricultural land in new member states.<sup>x</sup>

Recognising the high political sensitivity of this issue, the European Commission proposed in May 2001 that the candidate countries should be allowed to limit the acquisition of agricultural land by other EU nationals during a transitional period of seven years after their accession to the EU (European Commission, 2001a).<sup>xi</sup> During this period, the candidate countries would have to use objective, stable, transparent and public criteria for the authorisation procedures for land acquisitions. The Commission also proposed a review, to take place after three years, to determine whether this transitional period could be shortened or even lifted.

The Commission's proposal was perceived as a trade-off on a broader issue of far greater importance to the EU-15, that is, between the demand of the EU-15 for 5-7 year transition periods for the free movement of workers from Central and Eastern Europe (CEE), and the candidates' demand for longer transition periods for land purchases by non-residents. Most candidate countries endorsed and eventually adopted the Commission's proposal (Table 2). The only exception was Poland, which insisted on a longer transition period fearing that foreign residents might buy relatively cheaply its abundant reserves of agricultural land. As Poland has by far the largest

population among the new member states and at the same time there were fears in some old members of the EU that Polish workers might crowd out domestic labour after the accession, the Polish authorities managed to negotiate a 12-year moratorium on land purchases by non-residents in exchange for a seven-year transition period for the free movement of Polish workers to most EU countries.<sup>xii</sup> Most countries also negotiated the possibility to extend the seven-year transitional period by another three years if a special safeguard clause is invoked.

The right of EU nationals to purchase secondary residences in candidate countries was considerably less controversial. Cyprus, the Czech Republic, Hungary and Slovakia requested five-year transitional periods, mostly citing concerns about the impact of large-scale real estate purchases by foreign residents on the prices and affordability of local housing. The Baltic countries, Bulgaria and Slovenia, allowed EU residents to purchase secondary residences even before their accession talks and therefore requested no transitional arrangements at all, although Slovenia negotiated the right to invoke a general economic safeguard clause to protect its real estate sector over a period of seven years. Against this background, it is interesting that some media reported a different interpretation of Slovenia's position, according to which Slovenia tried but did not manage to negotiate a transitional period for real estate purchases.<sup>xiii</sup>

The European Commission's proposal for a five-year transitional period for secondary residences was eventually adopted by all new member states except Malta, which presented a special problem. Malta's case is instructive and deserves particular attention because of some similarities on this issue with the current situation in Croatia (see Box 1).

Another interesting example is Denmark. Foreigners are free to buy real estate in Denmark for business and primary residence purposes (subject to certain residency restrictions), but not as secondary homes. In particular, foreigners cannot own holiday homes along the Danish coast – such properties can only be rented out. This restriction dates back to the mid-1960s, when Denmark was not yet in the EU and there were fears that foreigners might buy holiday properties on the coast for speculative purposes. To prevent speculation, non-residents were not allowed to own vacation homes that are kept unoccupied most of the year. Upon accession in 1973, Denmark was allowed to keep this restriction.<sup>xiv</sup>

Table 2 Candidate country positions on acquisition of real estate by European Union nationals<sup>1</sup>

Country	Secondary residences		Agricultural and forestry land	
	Country's negotiating position	Transitional arrangement agreed with EU	Country's negotiating position	Transitional arrangement agreed with EU
Bulgaria	0 <sup>2</sup>	5	10	7 <sup>3</sup>
Cyprus	5	5	N <sup>4</sup>	N <sup>4</sup>
Czech Republic	5	5	10	7 <sup>3,5</sup>
Estonia	0 <sup>2</sup>	0	0 <sup>2</sup>	7 <sup>3,5</sup>
Hungary	5	5 <sup>6</sup>	10	7 <sup>3,5</sup>
Latvia	0 <sup>2</sup>	0	10	7 <sup>3,5</sup>
Lithuania	0 <sup>2</sup>	0	0 <sup>2</sup>	7 <sup>3,5</sup>
Malta	P <sup>7</sup>	P <sup>8</sup>	N <sup>4</sup>	N <sup>4</sup>
Poland	— <sup>9</sup>	5	18	12
Romania	— <sup>9</sup>	5	15 <sup>10</sup>	7 <sup>3</sup>
Slovakia	5	0	10	7 <sup>3,5</sup>
Slovenia	0 <sup>2</sup>	S <sup>11</sup>	0 <sup>6</sup>	S <sup>11</sup>

<sup>1</sup> Delay (years after accession to the EU) in the right of EU nationals to acquire secondary residences and agricultural and forestry land in candidate countries.

<sup>2</sup> No transitional periods or derogations requested.

<sup>3</sup> Excluding self-employed farmers.

<sup>4</sup> Cyprus and Malta were not required to liberalise land acquisition due to the very small size of agricultural and forestry land.

<sup>5</sup> Possibility to extend transitional period by 3 years if the country invokes safeguard clause.

<sup>6</sup> Excluding EU and EFTA residents residing in country for at least 4 years.

<sup>7</sup> Permanent derogation of the acquisition of secondary residences by non-residents and of real estate for speculative purposes.

<sup>8</sup> Permanent derogation: only EU nationals residing in Malta for at least 5 years can buy more than one property on the island.

<sup>9</sup> No information on the negotiating position available.

<sup>10</sup> In addition, five-year transition period for the liberalisation of land acquisition inside town limits.

<sup>11</sup> Special arrangement: possibility to resort to a general economic safeguard clause for 7 years in real estate.

Sources: Foreign ministries of new member states; European Commission (2001); Deutsche Bank Research (2000)

In summary, the cases of Malta and Denmark, along with the Polish extension of the period for agricultural land purchases by non-residents, illustrate that the scope for adopting solutions suiting the interests of candidate countries is not limited ex ante and depends, among other things, on the expertise and negotiating skills of public servants engaged in accession talks with the EU.<sup>xv</sup> Nevertheless, one

should not underestimate the difficulty of negotiations on this point. The arguments for either the Maltese or the Danish exemption may not be easily applied to Croatia. Moreover, as discussed in the conclusion, no country can expect to benefit from the rights of membership if at the same time it does not want to shoulder the obligations. The challenge in this particular case will be, first, to identify an important national interest (if any) in postponing the liberalisation of the real estate market for non-residents; and second, to demonstrate that applying unrestricted rights of EU residents to acquire property in Croatia would go against this interest for an extended period of time. One obvious candidate for such an interest is the need to limit property speculation. Such a move would not go against the spirit of EU accession because other EU member countries have such legislation. The sections that follow elaborate several other economic arguments that tend to support the case for a more gradual approach to the liberalisation of the property market.

**Box 1 How did Malta negotiate an exemption from the complete liberalisation of real estate sales to European Union residents?**

As in Croatia, non-residents – including from non-EU countries – could acquire property in Malta even before the country's accession to the EU. Restrictions on property sales were similar to those presently used in Croatia – the sale required prior approval, only one secondary residence of limited size could be acquired by non-residents, and the value of property had to be above a certain limit. The rationale for these restrictions was to retain a measure of control on land use and to prevent speculation. Foreigners could acquire additional property in Malta beyond the secondary residence only if they obtained Maltese nationality.

During accession talks, Malta requested to be able to keep these restrictions on a permanent basis. The authorities were in particular concerned that if EU residents had unrestricted access to the real estate in their small island country, this could lead to more widespread economic and social problems. They supported their case by several well-founded arguments.

First, they argued that, with population of 395,000 and territory of just 316 km<sup>2</sup> (by comparison, Croatian islands of Brač and Hvar have surface areas of 395 km<sup>2</sup> and 300 km<sup>2</sup>, respectively), Malta was by far the most densely populated country in the EU-25. As a result, land available for construction could only cover the basic needs of the local population.

Second, they argued that, if the right of EU citizens to buy property in Malta after membership led to an increase in demand for property, this could affect property prices and have a negative social impact on Maltese families, especially on young couples. While housing affordability is not only affected by EU membership – the property prices have been rising in Malta for many years – Malta's concern was that EU membership should not add to the problem by making housing even less affordable.

Third, they argued that concerns about housing affordability in their densely populated country were permanent because, should a problem arise, it would be greater in future than at present, affecting future generations more than the current ones. This is why a transitional period was not sufficient for Malta: only a permanent arrangement was acceptable.

The European Commission accepted these arguments and the EU eventually agreed that Malta may maintain, on a permanent but non-discriminatory basis, the existing restrictions on the right of EU citizens to acquire just one secondary residence in Malta. However, after residing in Malta for at least five years, EU citizens will be allowed to buy additional property beyond the secondary residence. The five-year residence requirement was the balance that was struck between the two diametrically opposed positions in Maltese and EU law. Under Maltese law, foreigners can never have full rights to buy property in Malta – that is, to buy property other than one secondary residence – unless they obtain Maltese nationality. On the other hand, under EU law, EU citizens have full rights to buy as much property as they like in any EU country without any need to reside in that country.

*Source: Busuttil (2002)*

## **IMPLICATIONS FOR CROATIA'S REAL ESTATE MARKET**

To understand the broader economic implications of a more liberal regime for the acquisition of property by foreigners, it is necessary first to consider some basic features of the real estate market in Croatia. One should note from the outset that there is very little published research on the economics of the Croatian property market.<sup>xvi</sup> Moreover, statistical data on the real estate market are very patchy.

Given the many transformations of this market (for instance, from state-owned, to company- and socially-owned, to privately-owned housing) and institutional differences with western European and former socialist countries, an empirical research programme on the economics of the real estate market would be extremely useful for researchers, policy makers and the real estate industry. This section can in no way fill this gap; it will only attempt to outline those features of the real estate market that might be relevant in the course of Croatia's EU accession.

The real estate market is usually one of the most closely watched sectors in mature market economies. It plays a crucial role not only because housing accounts for the bulk of the personal wealth, but also because of linkages with key investment, saving, and consumption choices of households and businesses. In addition, the real estate market affects competitiveness as a major input in the productive capacity, in particular in service oriented economies such as Croatia's, and as an important determinant of banking and equity market performance, both of which are highly affected by movements in property prices.

The real estate market in Croatia is still relatively small – construction and real estate industries account for around 13% of GDP, compared with 20-25% of GDP in many industrial countries, indicating considerable potential for future growth. The real estate market started to develop in earnest in the second half of the 1990s, after most of the housing and commercial property stock inherited from the socialist period had been privatised. Privatisation of housing led to an increase in the already high proportion of both privately-owned and owner-occupied housing. According to the 2001 Census, 96% of the 1.4 million permanently occupied dwellings in Croatia are owned by private individuals, and 83% are owner-occupied dwellings.<sup>xvii</sup> For comparison, in western Europe the share of housing owned by private individuals ranges from about 60% in Austria and Sweden to 90-95% in Belgium, Greece, Spain and Portugal; while the share of owner-occupied housing ranges from 38% in Germany to 80% in Ireland (OECD, 2001).<sup>xviii</sup> Croatia is in this respect similar to some other CEE countries, where privatisation has also resulted in a high level of owner-occupied housing.<sup>xix</sup>

There is little reliable information about the state of the housing stock in Croatia. Comparing the total number of households (1.48 million) with the number of permanently occupied dwellings indicates a small deficit in the housing stock (about 56,000 dwellings in 2001).<sup>xx</sup>

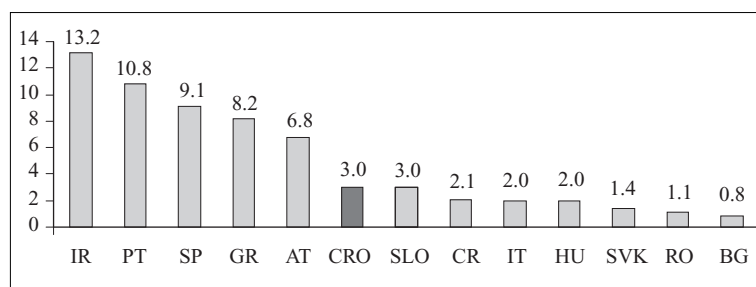


However, if one considers the additional stock of about 200,000 dwellings that are temporarily unoccupied, the number of dwellings exceeds the number of households by about 10%.<sup>xxi</sup>

The picture on the regional distribution of the housing stock is also unclear. The Ministry of Environmental Protection, Physical Planning and Construction (MZOUP, 2003:35) argues that there is a significant shortage of housing in middle-sized and large cities, and at the same time a significant surplus of housing in small towns. Large differences in apartment prices between cities such as Zagreb and Karlovac would tend to support this view. However, Tica (2004) argues that if temporarily unoccupied dwellings are counted, all Croatian counties, including the city of Zagreb, have a surplus in the housing stock.

Regarding housing supply, defined here as the flow of new housing (the “primary” market) plus sales of existing homes (the “secondary” market), the available data suggest that supply in the primary market is relatively tight. During 1996-2001, about 13,600 dwellings were on average completed each year.<sup>xxii</sup> To compare this figure with just one segment of the potential demand for housing, there were on average 70% more marriages (about 23,000) each year during this period. In international comparison, with an average of 3 newly completed dwellings per 1,000 inhabitants during 1996-2001, Croatia is near the bottom relative to western Europe, although it compares favourably with other central and eastern European countries (Figure 1).

Figure 1 Newly completed dwellings per 1,000 inhabitants



Data for Croatia: 1996-2001 average; for western European countries: 2000; for central and eastern Europe: 1998.

Sources: Central Bureau of Statistics (Croatia), OECD (2002), CIRIEC (2002).

Although there are no comprehensive data on sales in the secondary market, the available indicators suggest that the supply is constrained in this market as well. Perhaps the most important reason is that many properties – including many of those temporarily unoccupied – do not have clean titles, so many potential trades cannot be realised. As discussed below, this state of affairs is due to huge backlogs in the judiciary, the often chaotic state of property registers and deficiencies in urban planning and the enforcement of building relations.

Furthermore, much of the housing stock has been privatised to occupiers for nominal payments or at no cost. Privatisation thus resulted in windfall gains according to who happened to be living in a dwelling at the time. Many people therefore occupy dwellings that they would not otherwise be in a position to afford. Such properties are not likely to be offered for sale, which limits the effective supply.

The third reason is that standards of construction were often poor, resulting in problems with the quality of many existing dwellings. According to the 2001 Census, one-third of Croatia's housing stock is older than 45 years (i.e., constructed up to 1960); 60% was constructed between 1961 and 1990; and only 8% since 1991. From an investment point of view, the amortisation period for buildings is usually 50 years, so the bulk of the housing stock in Croatia is close to or past its useful life. This also means that privatisation has saddled many occupiers with liabilities in the form of high maintenance obligations.

Finally, as part of the economic transformation, the public sector has largely pulled out of the housing construction business, while private firms have not yet expanded sufficiently to bridge the gap in all segments of the market. In particular, the financial problems of the public sector have resulted in a sharp decline in the construction of social housing.

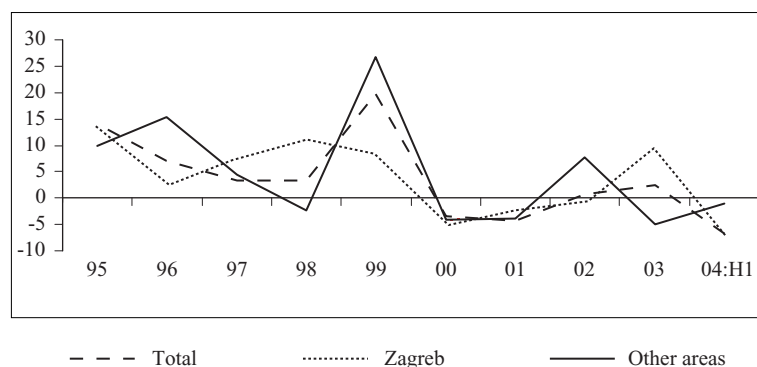
On the basis of these observations, one can form a working hypothesis that the supply of housing is presently tight in both primary and secondary markets. The question is, then, what is the likely impact of growing demand for vacation homes by foreigners on the residential property market? In particular, how realistic are fears, often expressed in the public, that rising prices of summer vacation homes along the Adriatic coast could spill over to the local housing market and negatively affect the affordability of housing for ordinary Croatian households?

The potentially most important channel for the transmission of price increases from the market for secondary residences to the residential housing market is the expectations channel. As with all assets, current prices of real estate depend on expectations of future prices. The housing market seems to be tight at the moment, so price increases in

the market for secondary residences are likely to be rapidly transmitted to other segments of the market. Most relevant in this context is the market situation on the Adriatic coast and islands, where most of the property sales to foreigners are taking place. The number of permanent dwellings on the coast and islands was 355,000 in 2001.<sup>xxiii</sup> In addition, Croatians owned on the Adriatic about 118,000 vacation homes in 2001, which represented two-thirds of the total number of such homes in Croatia. Thus, vacation homes are already a key segment of the housing market on the Adriatic, accounting for a quarter of the total housing stock in this region. Moreover, domestic and international media indicate growing interest of foreigners in buying property on the Adriatic, including for investment purposes.<sup>xxiv</sup> According to the news media, prices of houses and land for construction have risen by 20-30% over the past two years, and by 50-100% in most attractive locations such as the old city of Dubrovnik.<sup>xxv</sup>

Given the relative size of this market segment and of reported price increases, it is conceivable that rising prices of summer vacation homes and of land for construction could, as postulated above, spill over to the housing market for local residents and affect house prices and affordability. Yet in the primary market there is no evidence to substantiate these concerns. The average prices of newly completed apartments declined sharply after a run-up in 1999, and their growth remained negative during 2000 and 2001 (Figure 2). In 2003, prices increased only in Zagreb (by about 10%), while in the first half of 2004, prices of newly completed apartments declined in all locations.

Figure 2 Average prices of completed apartments (HRK/m<sup>2</sup>, annual percentage change)



Source: Central Bureau of Statistics

Data on sales of existing homes and land for construction provide more support for the spillover hypothesis. Between March and November 2004, house prices on the Adriatic increased at an annual rate of 10%, and prices of land for construction at an annual rate of 30% (Table 3). At the same time, house prices in Zagreb increased much more rapidly, while apartment prices on the Adriatic actually fell, indicating that property prices are also under strong influence of factors other than non-resident demand for vacation properties. Nevertheless, rising prices of houses and land for construction on the Adriatic reflect at least in part expectations about the future demand of foreign buyers. This is also confirmed by anecdotal evidence.<sup>xxvi</sup> More importantly, rising prices of land for construction can be interpreted as a leading indicator of future increases in house prices on the Adriatic.

Given the lack of comprehensive statistical data on property sales in the secondary market, the above results need to be interpreted with caution. Data used to construct Table 3 come from a commercial source, which publishes data at weekly frequency and with a relatively detailed breakdown. However, these data do not cover all properties offered for sale, and only indicate prices that are being asked by sellers rather than actual transactions prices. Because real estate sales are subject to the value-added tax or the property sales tax, Croatian tax authorities reportedly maintain a large data base on transactions in the secondary market.<sup>xxvii</sup> However, these data are not published, nor have they been made available to researchers.

Table 3 Real estate prices, November 2004<sup>1</sup>

		Houses	Apartments	Land for construction
EUR/m <sup>2</sup>	Croatia	1,100	1,466	43
	Zagreb	1,438	1,516	128
	Adriatic	1,096	1,402	32
Growth rate <sup>2</sup> (annual percentage change)	Croatia	10.5	4.5	26.5
	Zagreb	22.5	11.1	18.7
	Adriatic	10.4	-3.3	30.3

<sup>1</sup> Average prices based on 1,267 properties offered for sale on 4 November 2004.

<sup>2</sup> Estimated from linear regressions ( $\ln \text{price} = \text{const} + b \cdot \ln \text{time} + e$ ) of weekly data from 10 March 2004 to 4 November 2004.

Source: *Jutarnji list*, weekly supplements Real estate (based on [www.burza-nekretnina.com](http://www.burza-nekretnina.com)); author's calculations

The Croatian Bureau of Statistics only publishes data on average prices of newly completed apartments, on a quarterly basis and with

considerable delay (these data were used in Figure 2). The news media, on the other hand, suffer from sample bias: they tend to focus on properties in exceptional locations, often bought by domestic and international celebrities. The prices of such properties do not characterise general trends in the housing market, but they nevertheless affect market sentiment and sellers' expectations, which is reflected in figures reported in Table 3 and has also been reported by market participants. For instance, many real estate agents consider prices of properties offered for sale to be overvalued by about 30% on average.<sup>xxviii</sup>

Looking ahead, will the current conditions of relatively tight housing supply and rising prices of at least some houses and land for construction ease or become more pronounced with the opening-up of the market to non-residents? And what role will the speed of liberalisation play in this process?

Arguments supporting the view that pressures on the local property market might intensify fall into three categories. First, the number of properties sold to foreigners has been small to date. As noted above, since 1996 only about 3,200 property sales to foreigners have been approved. Even if the true number of realised sales is twice as high (due to provisions that allow foreigners to buy property via registered companies), this would represent less than 2% of the stock of permanent housing on the Adriatic (5% of the stock of summer vacation homes). Such a small market segment clearly cannot influence the overall real estate market. In the future, however, foreign demand for secondary residences is likely to be much higher, and might therefore have a more significant impact on developments in the housing market. As of September 2004, real estate brokers estimated the number of potential sales already in the pipeline at about 10,000 houses.<sup>xxix</sup> This is equivalent to 75% of the average annual supply of new housing in the entire country. A demand shock of this size would clearly have a big impact on the local housing market, even if the sales were realised over a period of 2-3 years.

The second concern relates to construction costs. If the construction industry is operating at full capacity, increased demand for vacation homes by non-residents will put pressure on housing construction costs in the short run, which will spill over to the market for permanent housing. To the extent that the construction industry is not competitive, the increase in costs – and hence the spillover on the local housing market – will be so much the higher. One should note that in the long run housing supply is elastic with respect to both income and price, so

capacity in the construction industry is not likely to be a factor constraining the supply of housing. But cost spillovers may be present in the short run and affect expectations of future prices, in particular if there is a sudden increase in demand.

The third concern is that for an average family the affordability of housing is already low, so that any spillover of price increases and construction costs due to the opening-up of the property market to foreigners might make housing even less affordable for the local population. However, concerns about affordability relate primarily to access to housing finance and public housing policy, and have little to do with non-residents' demand for vacation properties (see Box 2).

The main argument supporting the view that demand from non-residents will not affect future supply and price of local housing is that legal uncertainties relating to property transactions will be gradually removed as Croatia approaches membership in the EU and starts implementing the *acquis communautaire*. As noted above, many properties desired by foreign as well as domestic buyers do not have clean titles, so many potential trades have not been realised. In such circumstances it is not surprising that properties with clean title fetch higher prices. More importantly, legal uncertainty is presently constraining the potential supply of permanent housing in the secondary market. Clean property titles and orderly and more efficient cadastres will most likely bring many houses, apartments and pieces of land that are currently withheld from it onto the market, including some of the 200,000 temporarily unoccupied dwellings mentioned above.

The speed with which the property market is opened up to non-residents can tip the balance of these forces in an important way. Keeping restrictions on foreign ownership in place might sustain relatively high prices by limiting the supply of vacation properties to non-residents. However, the prices of such properties and real estate in general are bound to increase anyway with rising incomes in the long run.<sup>xxx</sup> The issue is then, how fast will prices of vacation properties converge to their long-term equilibrium? Given the apparent interest of foreigners in the Croatian property market, it is likely that a rapid removal of restrictions would lead to a large increase in demand for secondary residences, while at the same time the supply response would be less elastic due to legal constraints and limited capacity in construction industry. This would, *ceteris paribus*, imply faster convergence to long-run equilibrium prices, but with potentially significant spillovers onto the local housing market along the way. On the other hand, a more

gradual removal of restrictions would allow more time for the supply to respond to foreign demand, thereby limiting price increases in the short run and lowering costs of adjustment to the long-run equilibrium.

**Box 2 Affordability of housing, housing finance and public housing**

Contrary to widespread beliefs, the affordability of housing has not declined in recent years. Except in 1999, net earnings were growing faster than average prices of new housing (Figure 3). However, the index of housing affordability is very low in Croatia: an average annual income in 2003 was equivalent to the average price of just 5.5 m<sup>2</sup> of a newly completed apartment. In other words, one family member would need to put aside his or her entire annual income for ten years in order to save enough for a modest 55m<sup>2</sup> apartment, assuming that average income and apartment prices grow at the same rate. Affordability of housing is therefore a legitimate concern. However, one should not jump to the conclusion that housing would become more affordable if foreign ownership of real estate was more restricted. Housing affordability depends on many factors that have no connection to demand for vacation homes by non-residents. Two factors that are examined here are housing finance and public housing policy.

Figure 3 House affordability



Source: Central Bureau of Statistics; author's calculations

At present, the largest providers of housing finance in Croatia are commercial banks. Housing loans account on average

for one-third of commercial bank loans to households, which is low compared with mature market economies and some new member states.<sup>xxxii</sup> Moreover, housing loans in Croatia are still relatively expensive: they are mostly short-term products with a maturity of less than ten years (although longer-term loans are now being provided by some banks); the loan-to-value ratio is typically lower than the standard in advanced market economies; interest rates remain generally high both in nominal and real terms (although they have declined in recent years); loans provided with a fixed interest rate are still rare; and most loans are provided with a foreign exchange clause so that households bear the currency risk. Banks justified these practices in the past by the difficulty of enforcing foreclosure of residential properties. However, reforms in legislation and the judiciary over the past few years have made it easier for creditors to seize properties or attach salaries used as collateral for housing loans.<sup>xxxiii</sup> The fact that the restrictive practices in granting housing loans survive indicates that the housing loan market in Croatia is still relatively underdeveloped, and access to housing finance difficult for an average family.

The relatively high indebtedness of Croatian households represents a further constraint on housing affordability. In 2003 net earnings of Croatian households amounted to about 65 billion kuna, while outstanding bank loans to households amounted to 55 billion kuna.<sup>xxxiii</sup> This corresponds to a debt to income ratio of about 84%, which is higher than in the euro area (about 80%). On this basis, there would not seem to be much room for expanding household indebtedness, although there is considerable room for changing the structure of household debt toward more housing loans and fewer consumer loans.

What are the other options for improving housing affordability? Contractual savings and subsidised housing schemes are still relatively unimportant in Croatia. In the six years since the first housing savings banks were established, they made only 9,350 housing loans to a total value of 60 million euros, compared with accumulated deposits of around 470 million euros in mid-2004.<sup>xxxiv</sup> Judging from the experience of the new EU member states, the success of such housing schemes can be attributed largely to state-provided incentives. This, however, creates a considerable fiscal burden for the state. In 2003, the government of Hungary was forced to remove most fiscal incentives for housing, as their cost significantly contributed to the general government deficit of 9.3% of GDP in the previous year.



Given the pressing need for fiscal consolidation in Croatia, expanding subsidies to contractual housing schemes does not seem feasible.

Another approach to addressing housing affordability is via public housing policy. Even in countries with highly sophisticated financial systems some segments of the population (including the poor, people who are unable to work, and young couples) do not have access to housing finance. In Croatia there have been only two larger public housing schemes in recent years: one targeting handicapped veterans of the Homeland War; and the so-called POS scheme of public subsidies for housing construction. Under the former scheme, a total of 4,400 apartments have been constructed since 1997, with plans for a further 700 units. Under the latter scheme, 1,500 apartments have been constructed since 2000 and 8,000 more are being planned.<sup>xxxv</sup> The POS scheme has been criticised, however, for poor targeting (see Tica, 2002). In particular, many poorer households are not in a position to qualify for the scheme due to relatively high down payments (over 100% of average annual income for an apartment of 50m<sup>2</sup>) and debt servicing costs (about 30% of average income).<sup>xxxvi</sup> Taxpayers' money may thus have been used to assist the relatively better-off households, rather than the economically disadvantaged ones, to acquire low-cost housing.

A broader implication of this situation, rarely articulated in public discussions, is that the current younger generation finds it much more difficult to acquire own housing than the older generations. Under the socialist system, housing was for the most part provided by the public sector or labour-managed enterprises. Even after this practice was abandoned in the 1980s and families had to turn to the banks for housing loans, conditions for obtaining loans were comparatively benign. The state-owned banks extended housing loans with very long maturities, no required collateral or relatively small down payments, and at very favourable fixed interest rates, which significantly reduced the burden of debt service in an environment of high inflation.<sup>xxxvii</sup> This system was, of course, unsustainable especially once the government stopped bailing out the state-owned commercial banks. Since then, with the exception of public sector housing schemes mentioned above, housing loans have been provided at essentially market terms.<sup>xxxviii</sup>

In summary, there is some evidence that increased demand for secondary homes by non-residents may have already led to an increase in house and land prices on the Adriatic. The future effect will depend

on the speed with which the property market is opened up; capacity constraints and competition in the construction industry; the speed with which legal impediments to property sales are removed; and developments in household incomes, housing finance and other factors influencing the affordability of housing. In general, however, given the supply rigidities, one could expect that a measured approach to the opening of the real estate market to non-residents would allow for a more orderly adjustment than a rapid removal of restrictions.

## **IMPACT OF EUROPEAN UNION ACCESSION ON CROATIA'S TOURISM INDUSTRY**

The preceding sections identified the right of EU nationals to acquire property in Croatia as an important issue in forthcoming accession negotiations, and discussed potential implications of foreign investment in real estate for the local housing market. This section considers how developments on this front might influence Croatia's tourism industry.

As with the real estate market, the lack of rigorous economic analysis and adequate statistical data on tourism make it difficult to assess even the size and economic potential of this industry, let alone its dynamics in the context of Croatia's accession to the EU. One of the few analytical studies available is a report by the World Travel and Tourism Council (2004), which uses the methodology of tourism satellite accounts (TSA), developed by the OECD and the World Tourism Organization in the 1990s.<sup>xxxix</sup> This methodology aims at identifying more precisely different industries supplying the tourism output, and thus offers policy makers better insights into economic and other effects of tourism (see Annex).

The TSA methodology clearly indicates that travel and tourism is a key economic activity in Croatia: its contribution to GDP in 2003 is estimated at 28% (\$8 billion), and to total employment at 21% (294,000 jobs) (Table 4).<sup>xl</sup> The bulk of this contribution (\$4.6 billion, equivalent to 16% of GDP) comes from spending by international visitors on goods and services (so-called visitor exports). In terms of national accounts, travel and tourism contribute 44% of total exports, absorb 19% of total imports; and account for 11% of personal consumption and 11% of capital investment.

In international comparison, Croatia ranks 22<sup>nd</sup> among more than 160 countries in terms of the share of travel and tourism in GDP

(well ahead of Austria, Greece, Italy, Switzerland and new member states from central Europe); 16<sup>th</sup> in terms of the share of travel and tourism in total employment (behind Turkey, but well ahead of the countries mentioned above); and 13<sup>th</sup> in terms of the share of travel and tourism exports in total exports. However, in terms of government expenditure on tourism, Croatia lags far behind: national and local government agencies in Austria, the Czech Republic, Greece, Hungary, Italy and Switzerland spend between 3,5% and 7,5% of their total expenditure on tourism-related services, compared with just 1% in Croatia. This seems far too low, because local government initiatives (for instance, promotion of agro-tourism in Istria) can broaden the spectrum of services offered, increase tourist expenditure and perhaps extend the tourist season. The report sees strong growth prospects for Croatia's travel and tourism industry, which is projected to expand by nearly 7% per annum over the next ten years, much faster than either EU or world-wide demand for tourism.

*Table 4 Tourism Satellite Account for Croatia, 2003*

	In billions of USD	In percent of GDP
Travel and tourism consumption	6.7	23.3
Personal	1.6	5.7
Business	0.5	1.8
Corporate	0.3	1.1
Government	0.8	0.6
Government expenditure – travel and tourism services	0.0	0.0
Spending by visitors (visitor exports)	4.6	15.9
Travel and tourism demand	1.2	4.2
Government expenditure – collective services	0.1	0.2
Capital investment	0.6	2.2
Other (non-visitor exports)	0.5	1.8
Total	7.9	27.5
Employment	In thousands of employed	Percent of total employment
Directly in travel and tourism	139	10
Economy-wide	155	11
Total	294	21

*Sources: World Travel and Tourism Council (2004); author's calculations*

The question that arises against this background is to what extent the expected increase in investment in Croatian real estate by residents of the EU might change the outlook for and the character of travel and tourism industry over the medium term. One issue that seems particularly relevant in this context is whether accession to the EU offers the opportunity for tourism to assume a leading role in overall economic development, or represents the threat to what is widely considered to be the last remaining environmentally unspoiled area of the Mediterranean within easy reach of major European cities. To address these issues, it is necessary first to consider the main features of tourism in Croatia. As it turns out, Croatian tourism is in many respects very similar to tourism in other southern European countries, so useful lessons can be learned by referring to the experience of these countries.

The first point to note is that tourism in Croatia, as in other southern European countries, is dominated by international mass tourism. The main object of mass tourism is the beach holiday, with its natural (coastal environment, climate) and man-made ingredients (restaurants, hotels, etc) marketed as “sunshine and sea” packages providing an escape from the routines of domestic and work life. This social image of tourism and the lack of product differentiation imply a high degree of substitutability among different Mediterranean resorts. They offer similar experiences – the sunshine and sea are interchangeable – and virtually the only point of competition is price.<sup>xli</sup> Efforts to develop “elite” tourism focusing on high-income visitors or “sustainable” tourism aimed at keeping tourism resources available for future generations are not likely to succeed in replacing incomes generated by the mass tourism industry, which brings 8-9 million tourists to Croatia or 50 million tourists to Spain each year.<sup>xlii</sup> The Common Agricultural Policy of the EU, with its emphasis on farmers as keepers of the environment and on diversification of tourist destinations, has provided a boost to rural tourism in the EU, but while important in rural areas, the net effect on the tourist industry has been minimal (Williams, 2001).

The second characteristic of mass tourism is its extreme vulnerability to developments over which the industry itself has little control. One example is tourism’s high elasticity in relation to incomes.<sup>xliii</sup> Given that tourist activity does not, in the main, meet a vital need, tourist behaviour is highly volatile and subject to psychological and social influences, personal sensitivities, fashion, and short term reactions. If the image of just one link in the chain is affected, then the whole tourism industry suffers consequences. The most obvious manifestation of this sensitivity is the impact of political uncertainty or the

security situation of tourist arrivals in a given country or region. Croatia's experience during the 1990s is a clear case in point. However, the issue is present worldwide, especially since the terrorist attacks of 11 September 2001.<sup>xliv</sup>

The tourism practiced in Croatia and other southern European countries is also characterised by a potentially high level of systemic risk on the supply side. Threshold levels of capital and skills required for starting a tourism business – for instance, the letting of rooms – are relatively low. This means that there is a high elasticity of supply. While this has provided an important opportunity for social and economic mobility for lower income households, most of which used to be engaged in agriculture, the ease of entry into the tourism market may threaten the longer-term competitiveness of established tourist areas as new resorts develop. Moreover, it may threaten the competitiveness of existing resorts through overdevelopment and devastation of the landscape. This problem has been particularly pronounced in Croatia, where weaknesses of spatial planning and local administration, misplaced government incentives, and failure to control clandestine (“wild”) construction have forced the authorities to take drastic measures to prevent overbuilding and protect the public coastal domain (see Box 3).

### **Box 3 Clandestine construction and protection of the public coastal domain**

Clandestine construction has been a longstanding issue in southern European countries (see Mullins, 1991) and has recently become a major issue in Croatia. The phenomenon has diverse origins but a common outcome – devastation of the coastal environment, which is a key ingredient of the main tourism product of these countries, and hence a serious threat to their competitiveness.

The proximate causes of clandestine construction are deficiencies of spatial planning and local administration, and the failure of the authorities to enforce building regulations.<sup>xlv</sup> But the ultimate cause is more likely to be the lack of clearly defined property rights. This problem was highlighted by de Soto (2000) in his seminal study on establishing capitalism in developing countries. To illustrate the problem, de Soto tried to open a small garment factory in Peru. He discovered that to obtain a license to operate such a small business took 289 days and cost 31 times the average yearly minimum wage.<sup>xlvi</sup> Not surprisingly, most people bypassed the process, operating without a license. De Soto concluded that developing and

former socialist countries' principal problem in fostering private sector development was how to provide easy access to legal mechanisms such as property titles for land, houses and other assets that indigenous entrepreneurs own *de facto* but not *de jure*. Without property titles, people have no transferable rights of ownership with which to establish and operate their businesses.

In the case of Croatia, these problems have manifested themselves in long delays in obtaining clean property titles and building permits. For instance, Croatian courts have accumulated some 400,000 unresolved cases of property claims.<sup>xlvii</sup> There have also been many clear violations of regulations on spatial planning and construction, which captured domestic news headlines and prompted the authorities to take determined measures, including the demolition of illegally constructed dwellings.<sup>xlviii</sup> But misplaced incentives are also partly to blame. Until recently, the government subsidised loans for start-up businesses in tourism with the aim for promoting self-employment. However, most loans were used for construction of tourist apartments, often without building permits.<sup>xlix</sup>

To prevent further infringement of the coastline, the government passed in September 2004 *Regulation on the protection of the coastal public domain* (Government of Croatia, 2004). This regulation is similar to Spain's *Ley de las Costas*, passed in 1988 in response to environmental backlash against the overdevelopment of the coastlines, including by foreigners who acquired a large number of secondary residences.<sup>1</sup> The regulation protects all islands, the sea within 300 meters of the coastline, and coastal areas within 1 kilometre. It prohibits the construction of new houses and tourist apartments within 70 meters of the coastline. Except for infrastructure facilities, new construction within 100 meters of the coastline will be allowed only in the case of hotels and restaurants in specially designated areas. The regulation also restricts other construction in settlements where the majority of the population is local as well as in tourist resorts.

While this regulation may help solve some of the most acute problems of construction in coastal areas, Croatia will continue to face problems of the protection of the public coastal domain on a permanent basis, given that tourism results in extreme pressures on the local economy and environment at a few points in time and space. In particular, 95% of hotel and restaurant accommodation capacity in Croatia is located on the Adriatic Coast and islands, and over 60% of overnight stays are recorded in July and August.

A further notable development has been a pronounced tendency towards self-provisioning. It has been most visible in the accommodation sector and has started with the growth of second home ownership of local residents. The growth of “weekend homes” in Croatia and other southern European countries is also a broader economic and social phenomenon. In the former Yugoslavia it was partly a consequence of scarcity of other goods and services on the market on which to spend income on the one hand, and the basically free provision of services such as housing, education and health care on the other. At the same time, the widespread distribution of second homes across social classes and geographical locations reflects the persistence of rural-urban ties, with first generation urban dwellers inheriting homes in the countryside. Moreover, owning a weekend home in a coastal resort is a widely held aspiration and status symbol in all social classes, a part of the mythology of what constitutes social progress (Williams, 2001).

With enlargement of the EU to Portugal and Spain and the removal of restrictions on the movement of capital in the Union in the 1990s, there has also been a marked increase in second home ownership of foreign residents. For instance, in Spain there are an estimated 2 million second homes, one million of which are owned by foreigners (ibid., 2001). However, if the experience of other southern European countries can be a guide, one should not expect a significant increase in direct foreign ownership of tourist facilities other than second homes.<sup>li</sup> The reason is that foreign companies are mainly interested in facilities they can differentiate through branding and location, such as hotels aimed at business travellers or exclusive resorts. On the other hand, the tourism product being sold by Croatia (sun, sea, etc.) is largely indifferent to branding and location, so the emphasis is almost entirely on the value for money of the total holiday package. This situation is not likely to change with the growth of foreign ownership of vacation homes.

What are the major potential costs and benefits of increased foreign ownership of summer vacation homes for Croatian tourism? As noted above, the main potential cost is that of overdevelopment. Since this can result in the devastation of the coastal environment, which is one of the key attractions for tourists visiting Croatia, it would result in a loss of competitiveness for the tourism industry. One should also emphasise that there are many tourist attractions other than real estate on the Adriatic (see Kušen, 2002) that are not adequately protected and will need to be considered in the context of the opening-up of the real estate market to non-residents. The recent strengthening of building

regulations in coastal areas and the reasoned expectation that EU residents will respect these and other regulations (unlike many domestic developers in the past), provide some assurance that Croatia, unlike many coastal areas of Spain for instance, will avoid the overbuilding scenario. However, the authorities, in particular at the local level, should avoid complacency on this crucial issue, as weaknesses in the enforcement of building regulations have a long history in Croatia. The speed with which the real estate market is opened up to foreigners could make a difference here as well – a sudden increase in demand for vacation homes could increase incentives for local governments and developers to bypass the recently introduced building regulations and cash in on the interest of foreign buyers as quickly as possible.

Other potential costs for tourism are few and largely unrelated to foreign ownership of vacation homes. Croatia's tourism will in all likelihood continue to face the same challenges that it grapples with today: how to encourage greater market and product diversification; invest more in effective marketing and promotion; develop the human capital and technologies required for growth; create a more stable and predictable regulatory environment; match public and private infrastructure to customer demand; and promote responsibility in natural, social and cultural environments. It is unlikely that widespread foreign ownership of secondary residences will add to this long list of problems, the solutions for which are by and large well known but are difficult to implement because of the lack of co-ordination among different public and private sector bodies and weaknesses in local administration.

On the other hand, increased foreign ownership of secondary residences could have a number of potentially significant benefits for tourism and local communities. With the revival of interest by foreign buyers, houses and land that until recently had little or no economic value have practically overnight become a potentially important source of wealth for indigenous owners and local communities. In addition, much of the existing housing stock could be renewed by foreigners interested in owning old stone houses build in the authentic architectural style of this part of the Mediterranean. This would increase attractiveness of the Adriatic Coast and islands for other tourists as well.

Foreign investment in real estate could also revive local communities on the Adriatic. Demographic trends in many coastal communities and on most islands have been unfavourable ever since the late 19<sup>th</sup> century, and these trends seem to have accelerated over the past decade (see Wertheimer-Baletić, 2003). This has resulted in lack of investment



in housing, infrastructure and public services, with possibly tens of thousands of old houses falling into disrepair and many villages being abandoned. A trend observed in other southern European countries is that many second homes eventually become the principal homes of expatriate settlers, thereby generating year-round income streams and permanent jobs in local communities. These jobs might in turn lead to the establishment of many new households on the Adriatic, which could over time perhaps reverse negative demographic trends. The clearest examples of this course of development worldwide are the US states of Arizona and Florida, where many previously dormant communities have been transformed into vibrant centres of development after erstwhile tourists from northern states established their permanent residence in the south.

Local authorities and indigenous entrepreneurs would thus be well advised to use the current period of strong interest in Croatia as a tourist destination to plan for the future. Sooner or later, the demand and the supply are likely to shift – tourism, like any industry, cannot avoid changes in consumer preferences and the product life cycle. Or to put it differently, tourism is neither “a passport to development” nor a “unique devil” (de Kadt, 1979); its role in economic development depends on the form of tourism and on the structure of the national and regional economies within which it is inserted.

## MACROECONOMIC EFFECTS

What are the likely effects of increased foreign investment in secondary residences on the national economy?

One important macroeconomic effect – the wealth effect – has already been in evidence for some time. As noted above, the value of real estate and land in areas that are attracting potential buyers has increased even ahead of any large-scale property sales to foreigners. This clearly demonstrates the powerful impact that economic expectations exert on current asset valuations. It also implies that any tightening of restrictions on property sales to foreigners would result in wealth losses. In an extreme case, prohibiting the sales of real estate to foreigners would wipe out billions of euros of potential wealth of Croatian citizens and a proportionate amount of tax revenues.

Another key macroeconomic effect relates to the potentially large capital inflows associated with non-residents’ payments for prop-

erties purchased in Croatia. Considering only the estimate of house purchases that are currently being arranged – the sales of 10,000 houses mentioned above – and assuming a very conservative average price of 50,000 euros per house, capital inflows already in the pipeline would amount to about 500 million euros, or nearly 2% of GDP. To put this number in perspective, it is equivalent to the average annual net issuance of international bonds by the Croatian government during 1995-2003, or to 50% of the average annual inflows of foreign direct investment. An overly rapid liberalisation of the real estate market could thus unleash potentially significant appreciation pressures on the kuna, which could have important effects on the external competitiveness of the economy as a whole and export industries, including tourism.

The wealth effect and the associated capital inflows will be initially distributed among property and land owners on the one side, and the construction and real estate development industries on the other. Depending on how the income thus generated is spent and invested, one can envisage a number of different macroeconomic scenarios. One possibility is that property and land owners will use the bulk of the proceeds of real estate sales to finance personal consumption, while the construction and real estate development industries will use additional revenue largely to raise wages and dividend payments. This would result in rapid growth of personal consumption and imports, inflationary pressures, deterioration of the external current account, and eventually loss of competitiveness. Another possibility is that the capital generated by the real estate sales is reinvested in local housing, tourism enterprises, or other sectors of the economy. This would lead to demand pressures and additional imports as well, but in contrast to the former scenario the productive capacity of the economy would increase, helping to maintain longer-term competitiveness. Finally, the proceeds of property sales could be reinvested abroad, so the net effect of the inflow could be more or less offset by capital outflows.

There would in addition be a series of second round effects stemming from the consumption and investment patterns of foreign owners of secondary residences. If the residences are rented out to foreign holiday makers who would otherwise purchase accommodation from domestic owners of hotels or apartments, the income stream from tourism might be reduced. However, if secondary residences become the principal homes of foreign buyers, as has been suggested above, they may generate permanent income streams for local communities and the domestic economy.

The effects of property sales to foreigners on fiscal revenues are likely to be positive. The sales as well as any increase in personal consumption resulting from the sales will generate additional VAT revenue. Likewise, additional personal and corporate incomes generated by investing the proceeds of sales will at least partly be subject to income taxes. The overall fiscal effect will then depend on how additional revenue is spent by the local communities and the central government. Here one could consider the same scenarios as with personal consumption and investment: if additional fiscal revenues are spent on current public consumption, domestic demand pressures (and possibly imports) will increase; if they are invested in education, debt repayment, infrastructure, improvements in the functioning of public services and institutions etc, demand pressures may increase, but the competitive position of the economy will improve in the long run.

All of these effects have yet to be researched, so at present it is not possible to assess with any degree of certainty the likely macroeconomic effects of foreign investment in Croatia's property. Nevertheless, given the size of potential wealth effects and capital inflows, there are solid economic arguments in favour of a gradual rather than a swift liberalisation of the property market.

## **CONCLUSION AND POLICY RECOMMENDATIONS**

The main conclusion from the preceding analysis is that Croatia stands to benefit in the long term from foreign investment in the property sector, but in the medium term a measured approach to the opening-up of the market can be justified on a number of grounds. These include spillovers of price increases from the market for secondary residences onto the local housing market (of which there is already some evidence); costs of adjustment in the housing market and construction industry to a sudden large increase in demand for secondary residences; loss of competitiveness in the tourism industry in the case of violations of building regulations and the resulting overdevelopment of coastal areas (the incentives for which would increase if the property market is opened up suddenly); and macroeconomic pressures arising from large and sudden capital inflows.

Another general conclusion is that much additional research needs to be done on the economics of the real estate market, tourism

and on the macroeconomic effects of developments in the property market. In particular, major efforts at improving statistical information on the real estate market and tourism are necessary. For instance, without comprehensive information on transactions in the market for existing homes or in the housing construction industry, it is not possible to assess the overall state of the housing market, nor can one develop useful scenarios for the diverse macroeconomic effects of foreign investment in the property sector. In addition, the analysis has identified a number of weaknesses in the current legislative framework, from regulations on property sales to foreigners, to inadequate legislation protecting against property speculation, to the well-known problems with property titles, cadastres, and enforcement of building and spatial planning regulations.

Against this background, what approach could Croatia follow in negotiations on the free movement of capital with the EU? The difficulty of negotiations on this point can be better understood when put in the proper perspective of the way that negotiations are conducted. By joining the EU, a country accepts to adopt and apply the rules of the club. Exceptionally, the EU agrees that certain rules can be adopted over a longer time horizon after membership, provided that exceptions are limited in scope and in time. Exceptions are therefore temporary in nature and granted to allow a country sufficient time to adapt. In the case of Croatia, a transitional period for investment in real estate lasting four years from the entry into force of the SAA has already been agreed. However, Croatian authorities could decide to extend this period once negotiations on EU membership begin. But since other requests for transitional periods will undoubtedly be made in the negotiation process, the authorities will need to set up priorities among different areas, deciding whether, for instance, it is more important to request a longer transitional period for the real estate sector or for adjustment in agriculture.

Yet, if transitional periods are exceptional, it is evident that permanent arrangements – also known as derogations – are practically ruled out. The reason is that by their very nature derogations go against the principle that the law is equal for all (Busutil, 2002). Derogations also go against the spirit of acting in common, because they allow a country to operate outside the scope of the law binding all the rest. If derogations applied in all cases, there would be no common action and there would be little scope for having the EU at all. No country can expect to benefit from the rights of membership if, at the same time, it does not want to shoulder the obligations.

Although Section 2 highlighted some examples in EU law where derogations have been granted to individual countries to allow them to operate differently from the rest – for instance, the cases of Malta and Denmark in respect of restrictions on foreign ownership of secondary residences, and Poland in respect of agricultural land purchases by non-residents – it is not likely that Croatia will be able to wring any meaningful concessions out of the EU. The reason is that it would be very hard to prove that Croatia has a paramount reason for not allowing EU residents to buy property beyond one secondary residence. Inadequate legislation against property speculation is a weak excuse – adopting such legislation is in the interests of the country already, as domestic residents could engage in such activities. Likewise, it is not in the long-run economic interest of Croatian citizens and the authorities to further restrict foreign ownership of real estate, as this would wipe out considerable amounts of potential wealth and fiscal revenue. A well articulated public discussion could nevertheless help in formulating arguments to support Croatia's case on this and other important issues, and in deciding on the priority areas that need adjustment and hence longer transitional periods.

Turning to the real estate market, Section 3 identified two channels through which the opening of Croatia's real estate market to EU residents could affect housing prices and affordability: expectations of future price increases, and housing supply rigidities in the event a rapid liberalisation leads to a sudden increase in demand for property by foreign investors. Recommendations in this area are therefore more straightforward. First, the authorities need to stabilise the expectations that a housing boom on the Adriatic is imminent. Particularly helpful in this respect would be a more transparent and efficient application of existing regulations on sales of real estate to foreigners, and the continued determined implementation of the latest regulation on housing construction and protection of the coastal public domain.

Second, much can be done to improve the legislative framework and administrative procedures for property transactions. Legal uncertainty is probably a major constraint on the potential supply of permanent housing in the secondary market at present. Clean property titles and orderly and more efficient cadastres would bring to the market many houses, apartments and pieces of land that are currently withheld from the market.

Third, one aspect of housing finance that is visible in most industrial countries and many new EU members but is absent in Croatia

is involvement of the state in the mortgage market. Hungary and Poland, for instance, introduced legislation on mortgage bonds and mortgage banks following the German approach, while in Bulgaria, the Czech Republic, Latvia, and Slovakia commercial banks can obtain a mortgage banking license and issue mortgage bonds, which provide banks with an alternative tool to raise funds earmarked for housing loans. In addition, in most European countries the state has been providing a limited amount of housing loans directly, by establishing public funds to promote housing construction and finance. While Croatia has developed two such schemes, it is not clear that one of them (the POS scheme) is well targeted.

In Section 4 it was argued that the character of Croatia's tourism is not likely to change significantly with the growth of foreign ownership of vacation homes. While some additional pressures on the environment and local economies can be expected, they would not differ qualitatively from the pressures that tourist resorts are already experiencing with the robust growth of tourism in recent years. As for the broader implications of EU accession on Croatia's tourism industry, these can be largely separated from the issue of increased foreign ownership of vacation homes. Thus far there has been little EU intervention in the field of tourism. Freedom of movement provisions, competition law and other EU regulations have barely touched the tourism industry (Williams, 2001). Most tourism regions in Croatia will have to face choices about diversifying their source and product markets, imposing stricter development controls and improving the quality of their tourism product irrespective of accession to the EU. Given the ease of entry into tourism, which is dominated by fragmented indigenous capital, they will also face greater competition from other southern European destinations and the challenge of constantly adapting to new forms of demand. Some resorts may decline as a result unless they are reinvigorated by new investment and innovation. In this area, foreign investment in real estate could play a very useful role.

Regarding the macroeconomic effects of foreign investment in the property sector, no one knows exactly how many foreigners may eventually end up buying property in Croatia. Perhaps the share of secondary residences owned by foreigners will never be as high as for instance the 50% share in Spain. In the case of Croatia, this would imply purchases of some 100,000 vacation homes by foreigners, resulting in potential inflows of 5 billion euros, or 20% of GDP. But as argued in Section 5, even if foreigners purchase only a few thousand vacation homes, the

effects on the local and national economies would be sufficiently high to warrant caution on the part of macroeconomic policy makers.

## Annex

### **Measuring the economic impact of tourism: Tourism Satellite Account**

Tourism plays a significant role in many economies in terms of the production of goods and services and the creation of employment opportunities. However, tourism remains difficult to define and measure, and as a result the industry suffers from a credibility problem. In the case of conventional industries such as agriculture or manufacturing, the contribution of industry to GDP is measured from the supply side, i.e., from the value of goods and services they produce. In the case of tourism, this conventional approach covers mainly the output provided by the hotel and restaurant industry, which is equivalent to only about 3% of GDP in Croatia. Yet the contribution of tourism to GDP goes far beyond this narrow definition, to other industries supplying tourism output such as agriculture, fishing, the food industry, construction, transportation, cultural establishments, etc.

In the past, economists relied on estimates of income multipliers to approximate indirect effects of tourism on domestic industries other than hotels and restaurants.<sup>lii</sup> This methodology, however, is unreliable as it is based on many ad hoc assumptions. In contrast, TSA recast the national accounts so as to identify the diverse products and services that are delivered to domestic and foreign visitors. On the demand side, TSA include two basic aggregates:

- *Travel and tourism consumption*, which includes four components: (i) the value of products and services consumed by domestic and international visitors for personal travel and tourism; (ii) business travel by government and industry; (iii) expenditure by individual government agencies and departments that specialise in visitor services (cultural and recreational establishments, immigration and customs, etc) and (iv) spending by international visitors on goods and services (so-called visitor exports).
- *Travel and tourism demand*, which estimates a broader, economy-wide impact of tourism and includes three components: (i) public

spending on tourism promotion, aviation administration, security and similar services made on behalf of the community at large but closely associated with tourism (so-called collective government expenditure); (ii) capital investments to provide facilities, equipment and infrastructure to visitors and (iii) goods and capital sent abroad for ultimate sale to visitors or use by providers of travel and tourism services (so-called non-visitor exports).

On the supply side, TSA also produce two different aggregates: the *travel and tourism industry* and the *travel and tourism economy*. The former captures only the direct impact of travel and tourism for comparison with conventional industries such as manufacturing. The latter captures the broader, indirect, or economy-wide impact of travel and tourism. The TSA show separately the portion of travel and tourism supply that is imported (including expenditure on outbound travel by domestic residents), and also calculate direct and indirect components of value added produced by travel and tourism industry. Finally, the TSA show employment for travel and tourism industry and travel and tourism economy.

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- i *The excluded sectors are agricultural and forestry land, forests and areas protected under the Environmental Protection Act (NN 30/94), including national parks, nature parks and other protected areas of nature.*
  - ii *See "Information about acquiring real property ownership in Croatia for foreign citizens" on the website of the Ministry of Foreign Affairs [www.mvp.hr].*
  - iii *The lengthy approval procedure is perhaps more a reflection of red tape in various ministries and local governments involved (on this, see World Bank, 2004) than of the strictness of regulations per se.*
  - iv *Properties acquired by residents of Slovenia before the split of the former Yugoslavia are not affected by this regulation. Many vacation homes owned by residents of other former Yugoslav republics before 1991 have been sold in the meantime. However, the status of many resort properties and much commercial real estate owned by companies from the former republics is still unresolved (see Nacional, 22 June 2004 [www.nacional.hr]).*
  - v *Similar data were earlier quoted in Slobodna Dalmacija, 26 August 2004 [www.slobodnadalmacija.hr] and Nacional, 31 August 2004. Data reported in Table 1 were released after one member of the Croatian parliament officially inquired about this issue in the parliament.*
  - vi *Different news media have reported vastly different approval rates. According to Financial Times, approval to buy property is given to 95–98% of all applicants (FT House and Home, 15–16 May 2004; www.ft.com). However, according to Slobodna Dalmacija (26 August 2004) and Novi list (13 September 2004; www.novolist.hr), approval to buy property has been given to only 36% of applicants, which is closer to the subsequently reported official figures shown in Table 1.*



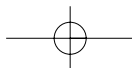
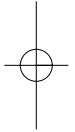
- vii See *Jutarnji list*, 20 March 2004 (weekly supplement *Real estate*, page 47).
- viii Property speculation is usually defined as the holding of unimproved or under-improved property for the purpose of reselling profitably without any substantial capital investment. Local authorities in Croatia currently impose a tax on unused land for construction and commercial property; however, the tax rate is fairly low (up to a maximum of 15 kuna, or 2 euros, per square meter), and unused residential property is not taxed (see Kesner-Škreb and Kuliš, 2001).
- ix The Croatian tax authorities define capital gains on property sales as the difference between the sale price and the purchase price of property adjusted for the producer price index of industrial products (see Law on the income tax, NN 127/2000, 150/2002 and 163/2003, paragraph 23). In other words, any increase in the value of property due to producer price inflation is not taxed.
- x See for instance Government of Bulgaria (2000) and Government of Romania (2001).
- xi Certain types of activities, in particular self-employed farmers who wish to establish themselves and reside in new member states, would be allowed to buy land immediately.
- xii Only Ireland and the United Kingdom have allowed free immigration of workers from new member states as of 1 May 2004.
- xiii See *Vjesnik*, 30 August 2004 [[www.vjesnik.hr](http://www.vjesnik.hr)] and *Novi list*, 13 September 2004.
- xiv See Treaty on European Union, Protocol (No 1) on the acquisition of property in Denmark, *Official Journal C 191*, 29/07/1992 p. 68.
- xv For an insightful game-theoretical analysis of negotiating strategies used by the EU and CEEC (including Bulgaria and Romania) see Papadimitriou (2002).
- xvi Recent references include Bezovan (2004); Družić (2001); Fröhlich (2003); and Tica (2002; 2004).
- xvii About 10% of dwellings are rented and 7% are shared with other families (2001 Census).
- xviii In addition to owner-occupied housing, other categories in this classification include privately rented, co-operative and social housing.
- xix In Bulgaria, Estonia, Hungary, Slovenia and Romania the ratio of owner-occupied housing exceeds 90%.
- xx This comparison assumes that in equilibrium the number of households is equal to the number of permanently occupied dwellings.
- xxi Temporarily unoccupied dwellings include vacant dwellings for rent or sale; those that are not used or rented by their owners; and those that are being refurbished. Note that vacation homes and apartments are not included in this category.
- xxii Comparable data for the more recent years are not available because of change in statistical methodology.
- xxiii Data for the coastal area and islands are approximated from census data for 7 counties abutting the sea.
- xxiv See for instance *International Herald Tribune*, 7 June 2004 [[www.ihf.com](http://www.ihf.com)]; *Financial Times*, 15–16 May 2004 and *Daily Mirror*, 8 July 2004 [[www.mirror.co.uk](http://www.mirror.co.uk)].
- xxv See *Vjesnik*, 14–15 August 2004, pages 20–21.
- xxvi See for instance *Večernji list*, 20 September 2004 [[www.vecernji-list.hr](http://www.vecernji-list.hr)]. According to *Vjesnik* (14–15 August 2004) and *Slobodna Dalmacija* (22 September 2004), prices of land increased in many areas of the Adriatic by over 100% in two years and, depending on the location, varied from 20–500 euros per m<sup>2</sup>.
- xxvii Newly completed properties are subject to the VAT at a rate of 22%, while sales of existing properties are subject to a 5% tax on real estate sales; see Kesner-Škreb and Kuliš (2001).

- xxviii See *Jutarnji list*, 20 March 2004 (weekly supplement *Real estate*, pages 44–45).
- xxix See *Slobodna Dalmacija*, 22 September 2004.
- xxx In the OECD countries, average house prices have not declined in nominal terms in any year since 1945.
- xxxi Housing loans account for 67% of total loans to households in the euro area and 64% in Hungary.
- xxxii For instance, in the municipal court in Zagreb there were 1,200 cases of foreclosure involving auctions of seized properties in the past four years (*Dnevnik*, 24 May 2004; [www.dnevnik.com](http://www.dnevnik.com)). In the municipal court in Split, 380 such cases were being processed in early 2004 (*Slobodna Dalmacija*, 7 May 2004).
- xxxiii The figure on net earnings was obtained as the product of average net earnings in 2003 (3,918 kuna per month) and average number of persons in paid employment in legal entities during 2003 (1.39 million).
- xxxiv See *Dnevnik*, 23 September 2004.
- xxxv See the web page of the Ministry of Environmental Protection, Physical Planning and Construction [[www.mzopu.hr](http://www.mzopu.hr)].
- xxxvi Down payment amounts to 131 euros per m<sup>2</sup>, and monthly debt servicing cost to about 160 euros for a 40,000 apartment [[www.mzopu.hr](http://www.mzopu.hr)]. As noted above, average monthly personal income in 2003 was about 520 euros.
- xxxvii A personal anecdote illustrates this point: when the author started his first job in 1982 and inquired about the burden of housing loans, one of his colleagues replied: “It’s really easy: the first few months your entire salary goes to repay the loan, and after a year or so the monthly payment costs the same as a bottle of wine”.
- xxxviii One should recognize at the same time that the current older generation is worse-off in terms of health care costs, which were fully subsidized during socialism but are now increasingly borne fully by the patients.
- xxxix Another useful study is the tourism development strategy elaborated by the IZTZG (2003).
- xl These figures are adjusted for the latest data on GDP and employment in 2003. The World Travel and Tourism Council (2004) used preliminary estimates of these series. On this basis, the contribution of travel and tourism in 2003 was estimated at 22.4% of GDP and 27.4% of total employment.
- xli Estimates of price elasticities of demand by tourists from western Europe and the United States for holidays in Italy, Greece, Portugal, Spain and Turkey range from –0.3 to –3.2. That is, a 1% increase in the price of a package holiday in country A will reduce the demand for vacation in that country by western European and US visitors by up to 3.2% (see Syriopoulos and Sinclair, 1993).
- xlvi It is interesting to note that social science researchers (including in Croatia) have shown considerable interest in sustainable tourism (see for instance Carić, 2003; Creaco and Querini, 2003; Petrić, 2003; and Petrin, 2004), but very little interest in analytical work on the economics of tourism.
- xlvi Average income elasticity of demand for holidays in Italy is estimated at around 2.0; in Greece and Turkey 1.8; Portugal 2.5; and in Spain 1.5. That is, a 1% decrease in income of western European visitors is associated with a 2.5% decrease in demand for holiday travel to Portugal (see Syriopoulos, 1995).
- xlvi See for instance Scottish Parliament Information Centre (2002).
- xlvi For problems of spatial planning in Croatia, see Kranjčević (2005).
- xlvi For other vivid examples, see World Bank (2004).
- xlvi See *Vjesnik*, 9 July 2004.



224

- xlviii *In the spring of 2004, a total of 185 properties were demolished (Vjesnik, 11 September 2004). The problem is even more pronounced in Albania: in January 2003 the government said only 500 of the 3,000 buildings on the 450 km coast were legal. It has since destroyed 1,000 and recently announced it would raze further 300 illegally built hotels and restaurants (International Herald Tribune, 23 September 2004).*
- xlix *See Dnevnik, 6 June 2004.*
- l *See Government of Spain (1988) and Ministerio de medio ambiente (2004).*
- li *For instance, Spain's 65 hotel groups own some 30% of hotel capacity (the rest are mostly small family-owned hotels). But only one-quarter of hotel groups have any foreign capital, and in only half of these groups does foreign participation exceed 50% of capital (Estudios Turisticos, 1988).*
- lii *See for instance Diamond (1969) and Sinclair (1998).*



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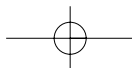
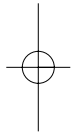
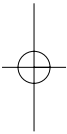
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## Chapter 9

# ACCESSION TO THE EUROPEAN UNION AND PHYSICAL (SPATIAL) PLANNING IN CROATIA

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## ABSTRACT

The increasingly rapid pace of social and economic development often brings different forms of land use (for residential, industrial or leisure and recreational purposes) into conflict. Since the territory does not close with the administrative boundaries of municipalities, cities, regions and the country itself, there are increasingly numerous demands for the space to be considered in a broader context, from the local to the European, in order to avoid disharmonies, adverse impacts and also to preserve individual values. Handling territorial problems and the planning of space do not refer just to the planning and harmonisation of various land uses, the protection of the environment, the natural and cultural heritage, but also impinge on the economy, law, social and welfare matters and science and politics. Since territory has become a new dimension of EU policy, the spatial development of the Union is one of the topics that have gained in importance in recent years. Accordingly, at EU level, institutions are being organised and documents developed and adopted to spur the harmonisation of country spatial policies, the planning of sustainable development, the preservation of individual diversities, and collaboration. Croatia too will be

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required to become acquainted with these documents and to apply them. The objective of this paper is to assess where physical planning is in Croatia as compared with the spatial development of EU member states, and whether Croatia has the strength to change its way of thinking, behaving and working in this domain, in order to be able to play an equal part in the creation of the European space.

**Key words:**

space, territorial cohesion, spatial development, physical (spatial) planning, Croatia, European Union

## INTRODUCTION

In the last ten years we have witnessed increasingly rapid social, economic and cultural changes at a global and a European level, which are particularly manifested in the space. Roads are being built, built-up areas enlarged, the areas of forest diminished, and statistical indicators show that the area of built-up and developed space is increasingly gaining at the expense of the natural space. Technology has made every part of the space accessible, and people are no longer so dependent on natural conditions, but on the degree of physical planning in which complex and interdependent social, economic, cultural and ecological processes unfold. This means that the space is constantly changing.

To clarify the importance of physical planning (spatial planning) in the process of accession to the EU, it is necessary to pay some attention to the significance of this activity. It is difficult to give a concise, simple and unambiguous description of concepts such as physical planning. Every country has its own expressions for the area: regional planning and physical planning. The European level, considering the size of the geographical unit involved, has introduced the terms spatial development and territorial cohesion. Put at its briefest, physical planning is the optimum distribution of people, assets and activities over a territory for the sake of its optimum use (Marinović-Uzelac, 2001). This distribution is harmonised pursuant to monitoring of the situation in the space and scientific research carried out by demographers, biologists, engineers and many other experts. In order to make review as simple as possible, the planned uses of the land for a given level are drawn in on certain graphic plans: geodetic or cadastral, for instance. Since physical planning is totally within the individual purview of each country, it

involves no elements of the *acquis*. At the EU level there is no uniform spatial legislation. However, each national law in the domain of physical planning must contain certain elements of the rule of law and order, the welfare state and the democratic society. In other words, "Regional/spatial planning gives geographical expression to the economic, social, cultural and ecological policies of society. It is at the same time a scientific discipline, an administrative technique and a policy developed as an interdisciplinary and comprehensive approach directed towards a balanced regional development and the physical organisation of space according to an overall strategy" (CEMAT, 1983). From this brief explanation we can see that physical planning is connected with a knowledge of the complex relationships in a society. For this reason, in the EU it is considered that physical planning in the member states should be founded on democratic principles, as well as comprehensive, functional, and oriented to the longer term.

How do the processes of accession and enlargement of the EU affect the area that surrounds us? With the growing economic and social integration, internal borders are increasingly losing the role of demarcation, not only in an economic and political sense, but also in a spatial sense. The migration of the labour force, the free movement of goods, services and capital, and cross-border cooperation lead to new relations in the space, both negative and positive, and thus to new spatial structures, not only in the member states, but also in the neighbouring countries<sup>i</sup>. For this reason it is to be expected that the new enlargements of the EU will bring about changes in spatial relationships, for example, to gradual shifting of industrial and agricultural activities eastward.

Although in public the process of the Croatian accession to the EU, as well as the enlargement of the EU, is justified and presented most often only from an economic or a political aspect, these processes have a major impact on the space, and hence lead to its transformation. Since according to one of the scenarios from the Vision Planet study (2000), the gradual transfer of economic power to the eastern part of Europe is envisaged, it is to be expected that the area of Croatia will be exposed to powerful and long-term changes. It is not possible to state with any certainty how and to what extent the accession process and the recent enlargement of the EU will affect the territory of Croatia. But it is very clear that there will be certain changes, and that for these reasons, Croatia should be better acquainted with and more involved in all the activities related to spatial development at the EU level.

In order to be able to understand the importance of physical planning in the Croatian EU accession process, the remainder of this paper deals with three topics: the importance of physical planning in the EU, the EU requirements on candidate countries, and the situation vis-à-vis physical planning in Croatia.

## **THE IMPORTANCE OF SPATIAL DEVELOPMENT IN THE EUROPEAN UNION**

In order for the importance of “space” to be as clear as possible in the European context, this part of the paper will briefly introduce international physical planning activities in the EU. The interest for regional and physical planning in the European continent has appeared as a response to the need to reduce the consequences of the unbalanced development of individual regions, visible in the economic and social differences between the north and the south, or the division of the EU into centre and periphery. Such difficulties can be overcome only if the space is looked at as a whole and common objectives for spatial development are defined. For this reason, from the European level, the space is considered not only within the confines of a single state, but also together with that of neighbouring countries, and after that as the space of a given region (for example, the Mediterranean space, or the Danubian, the Alpine or the Carpathian and so on), and finally as the space of the EU or indeed of the whole of the European continent. Apart from this, because of the need to harmonise the different national visions of spatial development (transport, watercourses, water management, environmental protection, nature or culture conservation), at the European level various documents are adopted such as charters, recommendations, declarations or conventions in which the common orientations are defined in principle. For this reason the EU puts a major onus for physical planning on the member states, which bind themselves to apply all these different documents in their national sectoral policies, strategies and plans.

The Council of Europe brought together the ministers in charge of regional and physical planning for the first time in 1970.<sup>ii</sup> Since then, at the European level, there has been official encouragement of the improvement of the methods and techniques for physical planning and cross-border cooperation for the solution of concrete problems. The fol-

lowing are some of the primary documents that have been adopted at ministerial conferences of the Council of Europe: The European Regional/Physical Planning Charter, better known as the Torremolinos Charter (CEMAT, 1983), The European Strategy for Regional/Physical Planning (CEMAT, 1988) and Leading Principles for Sustainable Development of the European Continent (CEMAT, 2000).

The Torremolinos Charter and the European Strategy for Regional Planning required member states to endorse an equalised social and economic development of society within the regions of Europe, an improvement of the quality of life, accountable management of natural resources and environmental protection, as well as a rational land use. The documents officially acknowledged the importance of international collaboration in the area of physical planning and asked all the member states to accept "realistic European planning" in their documents.

By accepting the Guiding Principles for Sustainable Development the member states of the Council of Europe identified physical planning measures aimed at enabling all their citizens an acceptable living standard. Since the principle of an acceptable standard of living is considered a precondition for the social cohesion and the stabilisation of democratic structures throughout Europe, these measures are of great importance. Guiding Principles also works as a basic signpost for the definition of land management policies at lower levels, so that practically all projects that are financed from such initiatives as Interreg, the Structural funds, Pre-accession and other funds are based on these principles.

An interest in patterns of regional development grew after, at the beginning of the nineties, the creation of the single market commenced. Kunzmann and Wegener (1991) published an influential article in which they argued for a polycentric system of cities as an alternative to the domination of just a few big centres, and the Dutch Agency for Physical Planning (Government of the Netherlands, 1991) created its report Perspectives in Europe, in which a concept of supranational physical planning was proposed, and an explanation was given of why national physical planning should take into account the European dimension of planning. In an analysis of the state of affairs in physical planning, the European Commission (1991; 1994) identified the main pressures on the European space stemming from social and economic development, as well as from national and regional interventions, and interventions of the Community. Two important growth focuses were identified (Northwest Europe and the northern part of the south, i.e., a

zone from Northeast Spain to North Italy and South Germany), and stronger collaboration in the field of physical planning in the whole area of Europe was sought.

Pursuant to this research, at a meeting of an informal council of ministers in the EU in charge of physical planning in their countries, the basic objectives of physical planning were accepted as economic and social cohesion, sustainable development, and the strengthening of the coherence of the European continent. The key principles for physical planning that were accepted were a better harmonised and polycentric urban system, equality of access to infrastructure and knowledge, and sensible management and sustainable development of the European natural and cultural heritage (European Spatial Planning, 1994).

The next important step in the development of physical planning was the adoption of an integrated multi-sectoral strategy for the spatial development of the EU (European Spatial Development Perspective; ESDP, 1999). When the ESDP was adopted, territory gained in importance as a “new dimension of European politics”. Member states were recommended in the implementation of the policy of the Union to pay greater attention to spatial factors in order to obviate regional differentials and to set up more balanced development. The European Physical Planning Observation Network (ESPON) was launched; this is a joint European Commission and EU member-states programme the aim of which is to explore spatial structures, trends and impacts of spatial policies in the EU.<sup>iii</sup> All old and new members of the EU, as well as Bulgaria and Romania, are involved in ESPON, but as yet Croatia is not, although it has sufficient information about its own space and spatial structures.

The acceptance of the ESDP (and the recent draft EU Constitution) mean that spatial development and territorial cohesion are gradually being brought into sectoral politics, and European institutions are continuing to strengthen the spatial component during reviews of certain policies (for example, on rural development or environmental protection).<sup>iv</sup> ESDP also constitutes an important document for the design of the spatial policy of the member states, and for the mutual harmonisation of the spatial interests of states and the EU in the area of spatial structure. Member states are duty bound according to ESDP to adjust their national interests with European interests (vectors of development, main ports and international infrastructure); the management of water (navigation routes, construction of hydroelectric generating stations, flood protection, protection against pollution); ecological networks; and rural development (changes from agricultural to residential or recreational use). One example of such obligations is the case of the

Czech thermonuclear generating station, Temelin, the planned enlargement of which was halted after negotiations between the Czech and Austrian governments, and numerous campaigns by NGOs.

The enlargement of the EU has meant that a large number of metropolitan urban regions and small and medium-sized cities have been included into the spatial structure of the Union, as well as a heterogeneous rural space, mountain regions and islands. In many new member states the capital city has a dominant position in the national urban system. But Poland, for example, has many large cities, and so the centre of gravity of the enlarged EU is moving eastwards, although it is still located on German territory. After the enlargement, the EU has about 70 cities with populations of over 500,000 in which about 20% of the total population lives.

Questions of spatial development are managed in the EU according to mutual cooperation, coordination and consensus, for the documents stated have the status of recommendations that do not necessarily have to be applied if they are not accepted in the national documents. But since in the framework of targeted programmes such as ESPON and Interreg considerable financial resources have been earmarked, member states have a financial interest in applying the mentioned recommendations of the EU.<sup>v</sup>

## EUROPEAN UNION REQUIREMENTS WITH RESPECT TO THE CANDIDATE STATES

Because of its role in the strengthening of the objectives of economic and social cohesion, spatial development is an important element in the enlargement of the EU. At the same time, because of spatial, historical, cultural and natural diversities at the European level, there is no single set of comparable territorial data – member states have only in the last few years been able to agree on reliable criteria and indicators to be applicable in all countries of the EU. The concepts and legislation in the systems of physical planning of the member states have also never been brought into line with each other.<sup>vi</sup> Accordingly, there is no *European* spatial legislation, only spatial legislation at the level of the member states. But in spite of this, inside the EU, there is a standard of management with the aim of a long-term vision of the development of physical planning, brought into line with the orientations of the EU and other international organisations.

For the candidate states, this means that in the area of physical planning there is no direct obligation with respect to individual chapters of the *acquis communautaire*. EU requirements relate primarily to the obligation of candidate countries to harmonise the policies and aims of their spatial development with the European objectives of spatial development, and to incorporate into the national legislation concerning physical planning certain mechanisms to harmonise the interests with the Union and other member states. One such mechanism is the obligation of the member states to base the preparation, drawing up and acceptance of physical planning documents at a national level on principles of law and order, the welfare state, financial justifiability and a democratic society. Another mechanism is that in the procedure of physical planning they respect international recommendations, directives, contracts and conventions, for example, from the area of the protection of the environment, the protection of the natural and cultural heritage, water management, the management of the coastline and the island areas. Given that sectors like transport, which are related to physical planning matters, also have to respect international agreements and special guidelines and instruments of the EU (for example, from the area of agriculture) and run and orient the vision of the development of their activities at the national level.

During the association process, new members of the EU, such as the Czech Republic, Slovakia and Slovenia, had first of all to assess the state of affairs in the space, determine their own objectives and policy for spatial development, and finally had to harmonise these objectives and policies with the interests of the EU. Thus in December 2001, Slovenia defined its new Policy of Physical Planning, and adopted its Assessment of the State of Affairs and Aspirations in Space, while it passed a new Physical Planning Law in 2002 (Zakon o urejanju prostora, UL 110/02). The basic doctrine of the new system inhered in the adoption of the principle of sustainable and harmonised spatial development of urban and rural regions, and instruments of an active land policy were provided for, from both local government units and from the central government. New rules were established, and a new manner of being involved in the procedure for the preparation and acceptance of decisions about the space.

From this, it can be concluded that in the process of joining the EU Croatia will be required to incorporate the following three elements from the domain of physical planning into its legislation:

- To ensure a much more stringent enforcement of the whole of the legislation relating to physical planning, for example, great authorities in the control of the space, an increase in fines in cases in which the laws are not adhered to, to provide the conditions for spatial plans to be carried out in such a way as to protect the natural and cultural diversity, to spare and preserve the land for the future generations, and so on;
- To incorporate into its legislation a provision concerning the participation of the public in the procedure of the preparation of physical plans (at the moment, public participation is provided for only during the drawing up of, and not during the preparation of, the physical plans);
- To create the conditions for the physical plans to be an expression of the realistic capacities of the society, and not just the visions of planners and architects, for which there is no real financial grounding. <sup>vii</sup>

It would be easy to meet these requirements if the EU were to check out only the extent to which they are incorporated into the letter of domestic law. However, negotiations about accession are held primarily about the conditions under which the candidate countries will apply and administratively and legally put through solutions in a given area accepted at the European level. The next chapter will discuss the unfortunately unsatisfactory state of affairs in the practice of physical planning in Croatia.

## PHYSICAL PLANNING IN CROATIA

This chapter will attempt to describe the existing state of physical planning in Croatia and compare it with the demands of the EU.

At the beginning of the nineties there were expectations that Croatia, as an independent state, would start off its spatial development on new grounds and with new objectives, as compared with the former system and state. Considering the long-term experience in physical planning, it was expected that the government administration would be mature enough to cope with new tasks in the domain. Not only were there home-grown examples of physical planning, but the experiences of highly developed countries in Europe were studied. Unfortunately, because of the poor working of the bodies of the government administration and the many social, political, economic and cultural changes, the physical planning system set off in a direction different than had been anticipated, and the planned development went much more slow-



ly than had been predicted. War damage, the introduction of parliamentary democracy, the strengthening of private property, the transition to a market economy, the new territorial organisation, the processes of European integration and globalisation all had the unpredictable consequence of a value-system crisis in physical planning, and a profound neglect of common and long-term interests in the space.

What problems are concerned here precisely?

The new units of local self-government and administration were not full prepared to take over, in addition to other matters, the tasks of planning their own space. In the greatest number of cases, units of local self-government adopted the physical plans from the old system, which were not adjusted to the new property rights, and hence to the interests of individuals or the community.

Property title began to be equated with the absolute right over real estate without any respect for the ensuring or protection of public interests. Because of the mistaken understanding of legal title to real estate, the number of illegal buildings and other operations in the space increased, and requirements of common interests, such as technical and social infrastructure, were neglected.

The system of physical planning should contain harmonised plans of the entire state, of regions, municipalities and cities. The central government level is responsible for the strategic outline of spatial development (the system of physical planning) and the application of elements that are of national interest: the determination of the main transportation corridors, the pipelines for gas and fuel, the electricity grid, the main ports and airports, special-purpose areas, national parks, nature parks, the main watercourses and so on. At the county level plans of physical planning that are of interest to the county are drawn up, such as the determination of the county transportation corridors, its infrastructure, protected natural areas, urban networks, tourism, and watercourses. Finally, the local level (municipality or city) is responsible for the spatial plans of interest to itself, that is, for the determination of the use of the space.

In conjunction with physical planning so structured, there is a need for complex horizontal and vertical sectoral coordination. In principle, all planning levels should be independent, but interlinked via collaboration, coordination and consensus. However, this kind of planning in Croatia in its current condition meets with enormous difficulties. When the new territorial organisation of 1992 came into being, some settlements that had previously been part of a larger municipality

became independent and were eligible to form bodies of local self-government. In this manner the democratic processes were continued at the local level, and units of regional and local self-government obtained the right and obligation to plan their own territory, and hence the preservation of their own identities. However, as many as 547 units of local self-government were set up (123 cities and 424 municipalities), many of them, because of shortfalls in their revenues, being unable to finance their own current requirements. For this reason the financing of development plans, spatial plans or projects for the development of individual sectors constituted obligations that could hardly be realised.

But there are also other problems that suggest the conclusion that at the level of local self-government, there is no quality communal economy, land and spatial policy concerned with the social, economic, cultural and ecological values of the space. One of these problems is that *the physical plans of the municipalities and cities in most cases remain at the level of determining building zones*. Here sight is often lost of the important consequence of dividing the space into building (i.e., land that is already built up or developed and which is planned for building development in the future) and non-building areas of the spatial plan. For example, it is common for the development of family farms to be held up. The physical plans of municipalities and cities also often do not have a clearly determined purpose for the space (tourist, industrial, areas of exploitation); sometimes the interrelated impacts of different uses of the space are not well-enough analysed (for example, the diminution of market value because of noise or the nearness of a source of pollution). Since the value of land is greater if it is defined as building land, the aim of almost every owner is that his plot of land should be declared building land. Since the determination of the building zones is in the competence of local self-management, the surface areas set aside for building are often larger than is needed by the settlement, as compared with its capacity. Although there are guidelines from the line ministry concerning rational procedures with land, as an important resource, during the definition of building zones, these guidelines are evaded, and the competent ministry has no legal authority to reduce the building area. For this reason the surface area of building zones tends to increase in the space management plans of the municipalities at the expense of the natural space.

A second problem at the local level is that *in a large number of cases the physical plans are ill-adapted to contemporary requirements*. Many of them are, for example, based on the principles of socialist-style

development, which is of course not suitable for the current trends in society and the economy, such as the development of private enterprise and a real-estate market. This disproportion is particularly clearly marked on the coast of the Adriatic, which has become an extremely attractive area for development and hence for real-estate investment (see Mihaljek, 2005). For example, for the purpose of incentives to the development of tourism, the Ministry of Tourism encourages the construction of tourist industry facilities via the provision of bank loans. This initiative, however, has not been accompanied by appropriate physical plans. Although authority to manage their own space have been conferred on local authorities, many of them do not have the technology, the finance and the expertise for this. For this reason in July 2004 the Parliament gave the Ministry of Environmental Protection, Physical Planning and Construction authority to take direct control of the adoption of physical planning documents for the protected coastal zone and the islands. Furthermore, in conjunction with the very large extent of illegal construction, a major problem in the disturbance of natural and aesthetic values of the space can be seen in the start-up of a large number of quarries, both in the interior and along the coast, facilities that most often are not planned for in the physical planning documents.

The third problem at the local level is that in the spatial plans of municipalities and cities, most frequently *potential or explored areas for the deposition or storage of waste are not defined*. The reasons for which this question is ignored are mostly the unclear rights of ownership to the land, the lack of prompt planning, and the lack of expertise in the solution of complex waste-disposal issues.

Fourthly, *a building zone on the whole tends to spread along the existing asphalted roads, without enough concern being devoted to the planned construction of the necessary technical infrastructure* (for example, pavements, water supply grids and drainage). Although possession of main services increases the economic worth of real estate, during the drawing up of plans not enough attention is devoted to the planning of the technical and social infrastructure. When settlements develop along the existing roads, their original form is lost.

Similar problems appear at the county level too. In accordance with the provisions of the Physical Planning Law, spatial plans have been drawn up and adopted for all the counties. However, these plans have not been harmonised with sectoral development plans (for example of agriculture, forestry, tourism, mining, culture and roads) at the county level (which have often not been actually laid down), and so the development of individual sectors will tend to be held up.

As compared with the municipalities and counties, not even the competent ministry for physical planning issues is in a more favourable situation when it is in charge of drawing up special-feature spatial plans. The biggest obstacles in such situations *are absence of or disunity among sectoral databases, unclear titles, geodetic plans that have not been brought up to date, an ignorance about sectoral plans, and a poor understanding of the interdependence of sectoral plans.* Because solutions to these essential problems are slow in coming, there is even more delay in the handling of the complex relationships of physical planning.

Pursuant to the spatial plans that have been drawn up, the competent institutions in Croatia should be able to take part in the implementation of international projects, since at the European level, this kind of collaboration is actually an international obligation. However, domestic and international projects are often interrupted and Croatia has thus no united, continuous and long-term projects for spatial development at all levels, and mutually harmonised high-quality sectoral databases. Projects are terminated because of the change in the political leadership or because of the departure of people who have no political position and yet nevertheless actually conceived the project. A frequent reason for projects being aborted is the reorganisation of some body of the government administration. Here too come the unsolved problems about the demarcation of competencies among ministries. The consequences of such a situation is that sometimes projects are financed that are not actually within the remit of given sectors. Thus for example the Ministry of Tourism finances the project for the restoration of rural houses named "Under Centuries-Old Roofs", although according to competence, this project should be financed by the Ministry of Culture. But the cause of projects being abandoned or collapsing is not just in the problem area of competence for the implementation of the project. Quite often projects have not been thought up with a sufficiently high-quality methodology and are not planned for the long term, and financial resources for their implementation have not been committed. Furthermore, during the drawing up of projects, sometimes not all the relevant sectors take part. Most often just those who devise the project participate, while, for example, the departments that have jurisdiction in the field of conservation of the natural or cultural heritage are insufficiently involved. These errors have been corrected in recent times, because those responsible for many projects became more aware of the importance of the protection of the natural and cultural inheritance. But still, no appropriate services to coordinate and run spatial development projects have been established, at either central government or lower level.

To what extent is the existing system of physical planning in Croatia in harmony with the Guiding Principles for Sustainable Development of the European Continent? At a formal level, it cannot be denied that there is a certain degree of harmonisation. In accordance with the provisions of the Physical Planning Law of 1994, the Strategy of Physical Planning of the Republic of Croatia (1997) and the Programme of Physical Planning of the Republic of Croatia (1999) were drawn up. In harmony with the Guiding Principles, these documents define problem units that have features in common: areas alongside the national borders; rural areas and villages; the rural area of hill and mountain country; the islands of the Croatian Adriatic; and, which form a distinctive and individual unit, the war-torn areas. So that the problems of these areas should be handled as effectively as possible, the areas so defined also have their own legislation. And in accordance with the laws, sectoral strategies programmes and plans are drawn up.

Although physical planning is not an expressly defined task of the EU, the financial obligations of the EU to the candidate countries clearly show the competence of the EU in the harmonisation of spatial policy matters (European Spatial Planning, 1999). In Croatia, there is partial harmonisation with the democratic principles of public participation in the adoption of physical planning documents. For example, according to the Physical Planning Law, the public can be involved during the procedure in which spatial plans are drawn up through the institutions of public scrutiny and public debate. However, as yet the public in Croatia does not have any part to play in the process of preparing documents of physical planning.

In harmony with general regulation of standards, there is also lack of legislative harmony in issues of the financial cogency of spatial development plans. Because of the unstable financial situation during the past few years, the documents of physical planning that have been drawn up have not been backed up with the appropriate financial analysis.

These shortcomings may not at first glance appear to be so very important. However, one should bear in mind that because the system of physical planning in Croatia is not adequately prepared to keep up with European trends, the accession process might lead to further major transformations in the space. Apart from that, during the association process, a clear establishment of order in the physical planning law is expected. This refers primarily to the establishment of the objectives of physical planning through which a more direct management of the space will be achieved, and a more effective supervision of legislation.

For an improvement of the existing state of affairs in the physical planning in Croatia it is necessary, as well as this, to ensure harmonised planning of the spatial, economic and social objectives of development. Finally, Croatia, like Europe as a whole, still has no uniform system of criteria and indicators to make possible a review and control of the implementation of the spatial development objectives laid down.

## CONCLUSION

Croatia occupies a very important geographical position between the west and the east of Europe, and between Central and Mediterranean Europe. Although the impact of the enlargement of the EU on the space of both Croatia and the new members is still unknown, because of the importance of its position, it is not unrealistic to expect a profound and long-lasting transformation of the Croatian space. Since Croatia cannot be separated from the European processes, it has to be involved in them actively, and make use of them to preserve and improve its own territory. For this reason the basic conclusion of this paper is that a new attitude to the space is needed, as well as a responsible and effective policy of physical planning to remove the previous weaknesses and to lay down the objectives and policies of spatial development in line with those of Europe.

What does this imply in concrete terms? Since Croatia is not yet a member of the EU, one important mechanism for the implementation of the objectives of spatial development is *participation in programmes of cross-border, regional and international collaboration* Interreg and Central European, Adriatic, Danubian, South-Eastern European Space (CADSES). These programmes take in areas beyond the borders of the EU and constitute starting points for further development of European spatial development policy, both for the space of the EU and for the space of the enlargement. Croatia should also, for the sake of the internal cohesion and balanced development of the EU, be interested in taking part in international spatial development projects such as ESPON. In the enlargement process, it is necessary in general to increase knowledge about the specific challenges that are posed during the enlargement of the territory of the EU.

Secondly, *all bodies that have spatial development within their purview should respect the fundamental objectives of the spatial development of the EU*. The perspective of the spatial development of Europe is founded on principles of even and sustainable development,

particularly via the strengthening of economic and social cohesion, and in the future probably on the principle of territorial cohesion. The harmonisation of the policy of spatial development of Croatia with European processes requires a new strategy. Accordingly, the existing framework for the policy of physical planning should be redirected and not only the decision makers in the central government and in the counties but also those in the municipalities and cities should be involved in the effectuation of it, since local authorities have a decisive effect on the space with their plans and measures.

Thirdly, Croatia should *be actively involved in the determination of internationally comparable spatial data*. These activities do not involve just the creation of statistically uniform data and institutions, but also the creation of databases for the monitoring of the state of affairs in the space at the level of municipality, region and state. Since such databases are the basis for physical planning and spatial development at all levels, it is important to agree on reliable criteria and indicators capable of assisting in the achievement of the objective of sustainable development.

Fourthly, although there is no *European* spatial legislation, in the accession process it is necessary *to harmonise certain legal regulations with European practice*. For example, the public should take part in the procedure for preparing spatial plans and defining what operations are to be conducted in the space. Spatial plans should contain a financial justifiability analysis. It is also necessary to strengthen control of the application of the laws. Finally, although the existing legislative framework does prescribe the relationships obtaining between planning documents of different levels, the relationships between the documents of the various sectors of the economy still have not been defined. Since it is competent for working out legislative and detailed plans of spatial development and physical planning, the Ministry of Environmental Protection, Physical Planning and Construction should bear the greatest burden of the harmonisation of legislation with European practice. However, other ministries too, which have in their jurisdiction some part of the competence for spatial development and management – for example, the protection of nature and water, culture, tourism, transport or development – will have to harmonise their own legislation and bylaws with the spatial legislation and *acquis* of the EU.

Formal regulations related to physical planning can indeed be changed overnight. However, the preservation and enhancement of the values in the space do not depend only on keeping to the letter of the

law, but also on the ethical and moral conduct of individuals and society as a whole. Here one should bear in mind that there is no universal recipe for a long-term sustainable social and economic development, and each state has to find its own way of arriving at a balanced stewardship of the space. Unlike the highly developed countries of Europe, in which space has gained in political importance, and has the character of a social value, the space in Croatia – except along the sea coast – has not become an adequate focus of social and political interests. Thus the blind copying-out of laws from individual areas and the introduction of new institutions following EU member states might have an effect quite opposite to that desired. There can be no success if issues of physical planning are planned and organised only at a central government or European level. Ideas, stimuli and visions must, to a very large extent, come from the population and from local self-government.

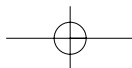
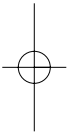
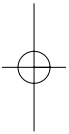
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- i *The spatial structure of Europe implies, for example, an understanding of the distribution of the population over regions, the regional GDP, and the relations of the regions with the potential core development area called the pentagon.*
  - ii *European Conference of Ministers Responsible for Regional Planning (CEMAT).*
  - iii *During 2002-2006, within the context of ESPON, diagnoses will be produced of the main territorial points of development at EU level, and the difficulties and potentials for territorial development will be defined: maps of the main spatial differences and their intensity; spatial indicators and typologies for the establishment of a balanced and polycentric development of the enlarged EU; and databases for the coordination of sectoral policies.*
  - iv *According to the provisions of Articles 1 through 3 Item 3 of the Draft EU Constitution (European Parliament, 2004), "territorial cohesion" has become a new EU objective. By way of comparison, in Article 16 of the EU Treaty, only two main objectives of the EU were stated: economic and social cohesion.*
  - v *Interreg is an EU initiative for encouraging inter-regional collaboration; see [www.interreg3c.net/web/home\_en].*
  - vi *The lack of harmonisation of European physical planning laws primarily refers to the area of unharmonised concepts, and in consequence to the concomitant legal and administrative procedures, such as the issue of building permits and appeals (Radna zajednica Alpe Jadran, 2002).*
  - vii *For example, the Physical Planning Law of 1980 contained a provision making it mandatory for physical plans to be backed up financially.*



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## Chapter 10

# HOW PREPARED IS CROATIA TO ACCESS EUROPEAN UNION REGIONAL POLICY FUNDS? THE CASE OF ISTRIA

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## ABSTRACT

This paper analyses the characteristics of EU regional policy and emphasizes the component of regional policy towards the Central and East European countries (CEEC) in the phases of candidacy and their full membership. Special importance was given to the possibility of Croatia to absorb funds offered by the EU. Potentials of Croatian regions are illustrated through the case of Istria, which successfully uses funds provided by the CARDS program and projects of Community Initiatives. In order to prepare Croatia (and its regions) as best as possible for use of these funds, it is necessary to set certain development documents, establish and reorganize (reassign) some institutions and improve cooperation with the EU regions.

### **Key words:**

regional policy, European Union, Structural funds, Cohesion Fund, new member states, Croatia, Istria

*\* The author would like to thank the referees who anonymously reviewed this paper.*

## INTRODUCTION

The goal of this paper is to add to the understanding of EU regional policy, to analyse the mechanisms of its functioning, as well as the opportunities for and challenges to Croatia and its regions in the utilization of available funds. The research took as its point of departure the following propositions: (a) EU regional policy contributes to the development of beneficiary regions and countries; (b) Croatia currently has very limited capacities to make use of EU regional policy instruments, and it is not sufficiently prepared to absorb such projects and programs; (c) Istria stands out in the efforts it is making and in the utilization of opportunities to participate in various projects and can, therefore, serve as a guide to other Croatian regions.

The paper begins with the fundamental characteristics of the EU regional policy, its principles and goals. The procedure for obtaining financial resources from the Structural funds (SFs) is outlined and the picture of future fund priorities and instruments is drawn. Then follows a detailed analysis of the allocation of the funds by the member states and the effects the funds have had in their economic development. Special attention is given to the analysis of regional policy with respect to CEEC, both while they had the status of candidates and, now, as full members of the EU, and the effects of the aid received.

The EU's position with respect to Croatia is reflected in the policy for the Western Balkan region, which also determines access to EU funds and programmes. The characteristics of regional policy in Croatia will be analyzed, highlighting the difficulties and disadvantages. The prospects for including the Croatian regions the EU programmes and projects is especially illustrated through the case of Istria, one of the most developed Croatian regions. This case, together with the analysis of procedures for receiving funds through various instruments of regional policy, has helped in the identification of measures that are essential for an improved, more extensive and more qualitative introduction of Croatia to EU regional policy.

## EUROPEAN UNION REGIONAL POLICY

### Main principles and objectives

The regional policy is based on *financial solidarity*, which means that all regions and their citizens should be able fully to use all the advantages of a common market and the economic and monetary union and aid to underdeveloped regions in the process of restructuring so they will be able to respond to the strong competition in the single market (Hitiris, 2003: 231). All the SFs' activities should be based on five principles:

- *concentration* refers to geographical concentration and it was defined through the SF goals (objectives);
- *programme planning* refers to multiannual programmes of allocation of regional policy funds;
- *additionality* means that national policies of regional development are supplemented with projects and financial resources from the SFs; these policies have to be complementary (Barnes and Barnes, 1995: 278-279);
- *partnership* means that European Commission and national authorities discuss the allocation of EU regional funds;
- *effectiveness* means monitoring and evaluation to ensure that the objectives are observed.

The fundamental criteria by which a certain region (country) is recommended as a beneficiary of regional EU policy funds are the following: below-average level of per capita GDP compared to the EU average, and above-average unemployment rate.

The basic solidarity instruments comprise four Structural funds: European Regional Development Fund (ERDF), European Social Fund (ESF), The Financial Instrument for Fisheries Guidance (FIFG), European Agricultural Guidance and Guarantee Fund (EAGGF – Guidance).<sup>i</sup>

#### **Box 1 The priority objectives of the Structural funds financing**

- Objective 1: Regions whose development is lagging behind the EU average (GDP per capita lower than 75% of the EU average; the thinly populated regions of Finland and Sweden and the most remote regions); providing them with the basic infrastructure

which they continue to lack or encouraging investment in economic activity. It targets 50 regions that represent 22% of the EU population and receive 70% of the total funding. All these regions post numerous negative indicators: low investment levels, a higher than average unemployment rate, lack of services for people and business, poor basic infrastructure.

- Objective 2: Areas facing structural difficulties (industrial or service sector subject to restructuring, loss of traditional activities in rural areas, declining urban areas, difficulties in the fisheries sector) supporting economic and social conversion in industrial, rural, urban or fisheries-dependent areas facing structural difficulties (high unemployment rates, poor areas, low level of employment etc.). This covers 18% of the EU population and receives about 11.5% of the total funding.
- Objective 3: Development of human resources – modernisation of systems for training (education) and employment promotion. This refers to the whole of the EU, except the regions included in Objective 1. This goal receives 12.3% of the total SFs funding.
- There are also four Community Initiatives (CI) seeking common solutions to specific problems. They account for 5.35% of the SFs on: cross-border, trans-national and interregional cooperation (Interreg III); sustainable development of cities and declining urban areas (Urban II); rural development through local initiatives (Leader +); combating inequalities and discrimination in access to the labour market (Equal).
- An additional 0.65% of the total SFs funding is spent on innovative measures, which are the only ones managed directly by the Commission and which deal with pilot projects or innovative strategies for cooperation and exchange of experience concerning local and regional development (European Commission, 2002c).

Apart from these four funds, the Maastricht Treaty also established the Cohesion Fund (CF), assigned aid to the four least developed countries: Greece, Portugal, Ireland and Spain, with per capita GDP lower than 90% of the EU average (in 1992). This fund now also benefits the ten new member states and finances projects in the areas of environmental protection and transport. During the period 2000 to 2006, the annual budget for the CF is projected to be 2.5 billion euro annually, i.e., 18 billion euro for a period of seven years.

## Funding from Structural funds

Funds are allocated in the form of non-refundable grants, according to particular programme periods. The SFs do not allocate funds directly to individual projects approved by the European Commission, as this is in the jurisdiction of national and regional authorities<sup>ii</sup>.

Once projects have been selected, they are financed from programme budgets composed of EU funds as well as of national sources (public or private).

The European Council determines the budget of the SFs and the rules governing their use, i.e., all members of the EU make decisions, on the basis of a proposal from the European Commission that has been negotiated with the European Parliament. Only then is the scheme of fund allocation by country and by goal defined. When this is established, each country or region elaborates its proposed development plan (for aid to areas with difficulties and for particular social groups). These plans are then sent to the Commission which discusses them with the member states. They also discuss the national and community resources needed for the implementation of these programmes. Once a consensus has been reached, the Commission accepts plans and programmes, and payments are made into the account of a particular member state. More detailed plans for those programmes (Programme Complements) are prepared by national and regional entities and the invitations for tenders are issued officially and publicly. The relevant authorities choose projects that best fit the programme goals. The progress of programme implementation is monitored by the national authority and the Commission is informed of the results.<sup>iii</sup>

On the other hand, CF and Instrument for Structural Policies for Pre-Accession (ISPA) do not co-finance programmes, but projects or parts of projects. Projects are submitted to the Commission, managed by national authorities and monitored by the Monitoring Committee. Successful implementation of these policies depends on close cooperation of European, national and regional authorities.

## The future of the European Union regional policy

The future of EU regional policy will be oriented to meet four challenges during the 2007-13 programming period:



254

- increasing cohesion in an enlarged Union (socio-economic disparities will double and the average GDP of the EU will decrease by 12.5%);
- strengthening EU priorities (the most successful and competitive knowledge-based economy in the world by 2010);
- improving the quality (capacity) to promote sustainable and more balanced development;
- creating a new partnership for cohesion (European Commission, 2004c: 28-29).

*Table 1 Structural funds: instruments and objectives now and in the future*

2000-06		2007-13	
Objectives	Financial instruments	Objectives	Financial instruments
Cohesion Fund	Cohesion Fund	Convergence and competitiveness	Cohesion Fund ERDF ESF
Objective 1	ERDF ESF EAGGF – Guidance FIFG	Regional competitiveness and employment – regional level – national level European employment strategy	ERDF ESF
Objective 2	ERDF ESF	European territorial cooperation	ERDF
Objective 3	ESF		
Interreg	ERDF		
URBAN	ERDF		
EQUAL	ESF		
Leader+	EAGGF – Guidance		
Rural development and restructuring of the fisheries sector (outside Objective 1)	EAGGF – Guarantee FIFG		
Nine objectives	Six instruments	Three objectives	Three instruments

*Source: European Commission (2004c:29)*

It is already known that approved funds for cohesion policy in the given period would be around 336 billion euros (European

Commission, 2004c). Regional policy will concentrate more on three objectives (now nine objectives), which will be achieved by using only three financial instruments (funds).

## STRUCTURAL FUNDS ALLOCATIONS AND THEIR EFFECT ON EU-15

SFs are the most important sources of EU aid to regional development. The share of countries in the allocation of the SFs depends on their economic development level.

### Structural funds allocations in the EU-15

For the period 2000-06, 213 billion euros are forecast for the EU-15, and an additional 22 billion euros for pre-accession aid and another 22 billion euros in structural interventions for new member states (2004-06), comprising a total of 257 billion euros. This sum represents 37% of the EU budget (European Commission, 2004c)<sup>iv</sup>.

*Table 2 Structural funds and instruments for the EU-15, in the period 2000-06 (millions euro, commitments in 2004 prices)*

Member countries	Obj. 1	Obj. 2	Obj. 3	FIFG	CF	CFs	Total	% popul. (O 1+O 2)	Allocation by country (%)
Austria	288	740	585	0	0	395	2,008	28.2	0.9
Belgium	690	486	817	33	0	231	2,257	12.5	1.0
Denmark	0	199	397	221	0	92	909	10.2	0.4
Finland	1,008	541	442	33	0	280	2,304	51.7	1.0
France	4,201	6,569	5,013	254	0	1,155	17,192	34.0	7.4
Germany	22,035	3,776	5,057	121	0	1,775	32,765	29.8	14.0
Greece	23,143	0	0	0	3,388	952	27,483	100.0	11.8
Ireland	3,409	0	0	0	584	183	4,177	26.6	1.8
Italy	24,424	2,749	4,129	110	0	1,294	32,707	46.5	14.0
Luxembourg	0	44	44	0	0	14	103	28.2	0.0
Netherlands	136	861	1,866	33	0	719	3,615	15.0	1.5
Portugal	21,010	0	0	0	3,388	741	25,139	66.6	10.8
Spain	42,061	2,904	2,363	221	12,357	2,162	62,067	80.7	26.6
Sweden	797	431	795	66	0	307	2,396	18.9	1.0
UK	6,902	5,068	5,046	132	0	1,061	18,209	32.2	7.8
EU-15	150,104	24,367	26,553	1,226	19,717	11,361	233,328	40.3	100.0

Source: European Commission (2004c:13)

The most funds for Objective 1 in the period 2000-06 will be received by Spain, Italy and Greece. The most funds in Objective 2 were assigned to France, the UK and Germany. These three countries will also receive the most through Objective 3. Spain, Italy and Germany receive the largest share of total funding.

### Effects of European Union regional policy on countries within the Cohesion Fund

The results of EU regional policy show positive trends, best observed through certain economic movements by a comparison of indicators for 1991 and 2002 for countries within the CF.

*Table 3 Comparison of economic indicators: effects of European Union regional policy (in %)*

	Greece		Ireland		Portugal		Spain		EU-15	
	1991	2002	1991	2002	1991	2002	1991	2002	1991	2002
Employment rates	53.4	56.9	51.4	65.0	68.0	68.6	49.2	58.4	62.2	64.0
Unemployment rates	9.7	10.0	11.9	4.3	7.4	5.1	22.3	11.4	–	7.3
GDP per capita in PPP (% of EU-15 average)	60.6	70.8	76.8	125.3	65.0	70.6	80.7	86.0	100.0	100.0
	91-95	96-01	91-95	96-01	91-95	96-01	91-95	96-01	91-95	96-01
Average annual GDP growth rates (constant prices 1995)	1.3	3.6	4.8	9.1	1.8	3.4	1.5	3.6	1.6	2.5

*Source: European Commission (2004a).*

Data from Table 3 illustrate the results of access to regional policy funds:

- the employment rates significantly increased in Cohesion countries, and in Ireland and Portugal in 2002 employment rates were higher than EU-15;
- the unemployment rates decreased and Ireland and Portugal have the lowest unemployment rates among Cohesion countries;
- the GDP growth rates of Cohesion countries, except Ireland, surpassed the average of the EU by 1% per year in the period from 1996-2001; the growth of GDP in Ireland was several times faster than the

EU average, the result of major efforts of national policy and also EU regional policy;

- GDP per capita increased in all Cohesion countries, and Ireland had the biggest level, above the EU average in 2002 (it is no longer eligible for the CF).

## **REGIONAL POLICY OF THE EUROPEAN UNION TOWARDS NEW MEMBER STATES**

The EU was enlarged on May 1, 2004 by ten new member states. This enlargement is historical for several reasons: it is the biggest enlargement there has ever been; and these countries are underdeveloped as compared to the EU average. EU regional policy towards the new member states can be observed in two phases: before and after accession to the EU.

### **Regional policy of the European Union before the latest enlargement**

The EU developed numerous programmes to aid the CEEC to achieve faster and more qualitative reforms and the fulfilment of criteria for EU membership. The most important and the richest programmes are the following:

- PHARE programme, focused on two priority areas: (a) the building of necessary institutions in the process of approach of these countries to the EU and (b) the financing of investment projects during the period 2000-06.<sup>v</sup>
- ISPA programme funds are used through investment projects for building transport infrastructure and infrastructure related to environmental protection.<sup>vi</sup>
- Special Accession Programme for Agriculture and Rural Development (SAPARD) is oriented towards solving problems of structural adjustments in the sector of agriculture and rural development of candidate countries, and to provide assistance in utilization harmonisation with EU legislation in the sector of agricultural policy. The countries entering the EU were included in the Common Agricultural

258

Policy of the EU and, in this way, they will receive support in the development of this sector.<sup>vii</sup>

To absorb successfully aid received through various programmes and in order to achieve high economic growth in all its regions, a country must make a lot of effort to build an efficient institutional framework that allows the successful management of future EU funding (Lajh, 2003).

Regarding the entrance of the eight CEEC in the EU, access to these programmes will now be reduced because these countries will now be able to make use of the SFs and CF<sup>viii</sup>.

*Table 4 Total sum of PHARE, ISPA and SAPARD by country (in millions of euro)*

Countries	PHARE 1990-2002 (payments)	ISPA 2000-2003 (payments)	SAPARD 2000-2Q 2003 (payments)	Total	Total funding (euros per capita)	Payments/ commitments (%)
Bulgaria	827.6	61.3	29.0	917.9	112.6	51.3
Czech Republic	490.5	90.0	26.3	606.8	58.9	53.4
Estonia	195.0	32.3	15.9	243.2	177.9	56.2
Hungary	968.7	114.4	9.5	1,092.6	107.1	63.6
Latvia	249.0	50.7	12.4	312.1	89.3	53.9
Lithuania	330.4	71.2	25.2	426.8	180.4	44.6
Poland	2,099.5	376.2	42.5	2,518.2	65.2	49.4
Romania	1,084.6	136.4	37.5	1,258.5	56.1	40.5
Slovakia	343.6	58.7	5.7	408.0	75.8	51.0
Slovenia	195.7	22.0	5.3	223.0	112.1	60.1
Czechoslovakia	228.9	–	–	228.9	–	–
East Germany	28.9	–	–	28.9	–	–
Multi-country programmes	1,706.6	–	–	1,706.6	–	–
<b>Total</b>	<b>8,748.9</b>	<b>1,014.2</b>	<b>209.4</b>	<b>9,972.5</b>	<b>95.6</b>	<b>50.1</b>

*Source: European Commission (2003a; 2003b; 2004b).*

The CEEC received various amounts of assistance per capita: Lithuania and Estonia received the most, while Romania (it is not yet an EU member) and the Czech Republic received the least (Table 4). There was a very low rate of accessing total commitments, the lowest rate being for the ISPA and SAPARD programmes (23% and 33%). The PHARE programme is the best exploited, and payments represent 63% of total commitments. Hungary and Slovenia are the most successful countries in absorbing pre-accession aid.

*Table 5 Comparison of economic indicators for Central and East European Countries: effects of pre-accession aid*

	Employment*		Unemployment		GDP per capita in PPP		GDP growth rates	
	(%)	(%)	(%)	(%)	(% of EU-15)	(% of EU-15)	(average annual)	(average annual)
	2002	1991	2002	1994	2002	1991-95	1996-01	
Bulgaria	50.6	11.1	17.8	26.6	26.4	-3.2	0.2	
Czech Republic	65.4	4.1	7.3	–	61.6	-0.8	1.6	
Estonia	62.0	–	9.5	32.1	43.3	–	5.7	
Hungary	56.2	7.8	5.6	46.3	53.3	-2.2	4.0	
Latvia	60.4	–	12.6	26.6	38.1	–	5.8	
Lithuania	59.9	–	13.6	27.8	39.8	–	4.6	
Poland	51.5	11.8	19.8	38.5	41.7	2.3	3.3	
Romania	57.6	3.0	7.5	–	26.4	-1.8	-0.1	
Slovakia	56.8	11.8	18.7	45.4	47.1	-2.6	3.7	
Slovenia	63.4	10.1	6.1	62.5	69.5	-0.4	4.1	
EU-15	64.2	–	7.7	100.0	100.0	1.6	2.5	

\*Data about employment rates were not available for 1991.

Source: European Commission (2004a); Eurostat (2003); WIIW (2003).

By reference to the data in Table 5, we can conclude that most CEEC improved GDP growth rates in 1996-2001 but did not solve the problem of higher rates of unemployment and lower employment rates than in the EU as a whole. Per capita GDP increased in all countries except Bulgaria but is still at a very low level. There was no direct correlation between aid received and economic performance; for example, the Czech Republic received a small amount of aid per capita but it had a very high employment rate (above the EU average), a low unemployment rate, and the second per capita GDP in EU-15 per cent terms in the CEEC. On the other hand, Lithuania and Estonia had high growth rates of GDP in 1996-2001, but also lower employment rates and higher unemployment rates than the Czech Republic. Based on these indicators, it cannot be concluded that EU assistance through the various programmes contributed to any significant growth in the CEEC. This is understandable, since their starting positions were marked by legacies significantly different to those of the other less developed EU countries (Greece, Spain, Portugal). However, the assistance programmes of the EU produced results in the development of the infrastructure, institutions and markets of all countries. It is evident that the countries should not expect the EU to solve their economic problems. They should create a qualitative development strategy in which EU assistance repre-

260

sents only one of the resources necessary to support the accomplishment of the goals that have been defined.

In addition to the PHARE, ISPA and SAPARD programmes the CEEC were given opportunities to participate in one of the CIs – Interreg III, which relates to the border regions between the EU and CEEC. It is important for strengthening economic and social cohesion throughout the EU, by fostering balanced development of the continent through cross-border, trans-national and interregional cooperation.

### Regional policy of the European Union after the latest enlargement

After the accession of 10 candidates to full membership, regional disparities increased even more. New member states become eligible for access to funds from SFs and CF because of the low level of per capita GDP in comparison with the EU average (Table 5). Funds in the CEEC are directed to those goals of economic and social development set individually for each member country.

*Table 6 The allocation of Structural funds and Cohesion Fund to the new member states in the period 2004-06 (in millions of euro)*

Country	Obj. 1	Obj. 2	Obj. 3	Interreg	Equal	CF	Total	% population (O1+O2)	Allocation by countries (%)
Czech R.	1,454.3	71.3	58.8	68.6	32.1	936.1	2,621.2	92.0	10.7
Estonia	371.4	0.0	0.0	10.6	4.1	309.0	695.1	100.0	2.8
Cyprus	0.0	28.0	22.0	4.3	1.8	53.9	113.4	30.9	0.5
Latvia	625.6	0.0	0.0	15.3	8.0	515.4	1,164.3	100.0	4.8
Lithuania	895.2	0.0	0.0	22.5	11.9	608.2	1,537.7	100.0	6.3
Hungary	1,995.7	0.0	0.0	68.7	30.4	1,112.7	3,207.4	100.0	13.1
Malta	63.2	0.0	0.0	2.4	1.2	21.9	88.7	100.0	0.4
Poland	8,275.8	0.0	0.0	221.3	133.9	4,178.6	12,809.7	100.0	52.4
Slovenia	237.5	0.0	0.0	23.7	6.4	188.7	456.3	100.0	1.9
Slovakia	1,041.0	37.2	44.9	41.5	22.3	571.0	1,757.4	91.9	7.1
Total	14,959.7	136.5	125.7	478.9	252.1	8,495.5	24,451.2	97.7	100.0

Source: European Commission (2004c).

These new member states will receive a total of 24.5 billion euros during three years, mostly through Objective 1 and CF. In the

majority of countries the entire population is in the area eligible for Objective 1 and 2. Poland and Hungary will receive most of the total funding.

## **CROATIA AND EUROPEAN UNION REGIONAL POLICY FUNDING**

Croatia entered the process of the transition of its entire economic and political system at the same time as the CEEC, with the purpose of establishing a market economy. Large regional disparities are one of the problems that Croatia inherited from the former state and the situation worsened significantly during the war (through emigration, destruction of infrastructure, closing of companies) pushing areas already poor into deeper underdevelopment.

### **Croatian regional policy**

In the last decade Croatia has not had a coherent strategy of regional development. What regional development legislation there was tended to be partial, merely regulating relief for certain specially defined areas (for instance, tax reductions and exemptions for the population of the war-affected areas) (Čavrak, 2003).

There is no document capable of encompassing the problem of regional development in the entirety of Croatia. However, increasing attention is now being paid to regional development through projects and legislation. The Concept of Regional Economic Development of Croatia was created in 1999. It stipulates that regional policy has to be decentralized and implemented at the national level<sup>ix</sup> (Frohlich, 1999).

The document "Development Guidelines of the Republic of Croatia" (a part of the Strategy of Development of the Republic of Croatia "Croatia in the 21st century") was adopted in 2001 (Government of RC, 2001a). This document gives special significance to investments in infrastructure, which would, consequently, initiate development of mountain, border, and island (depopulated) regions. The document "Development priorities of the Republic of Croatia 2002-04" (Government of RC, 2001b) was adopted in 2001 and it further elaborates the question of regional development. The following are empha-



sized among goals of regional development: harmonization of the regional system with the EU system; establishment of a regional policy by Croatia starting to utilize resources from the EU funds for regional development in the shortest period.

The Law on the Fund for Regional Development (NN 107/01) and the Law on the Fund for Development and Employment (NN 107/01) were passed subsequently. The Fund for Regional Development is intended to support the development of areas affected by the war, thinly populated regions, areas of special state concern, islands, highland and mountain areas, border areas, areas with structural problems. The continuity of such a policy was ensured by the adoption of the Law on Islands (NN 34/99, 32/02), the Law on Areas of Special State Concern (NN 26/03), the Law on Highland and Mountain Areas (NN 12/02, 117/03). Thus the Croatian authorities are paying special attention to the less developed regions in the country, but the policy is fragmented, and it has not achieved the expected level of positive results. This policy, which applies only to less developed regions, has to be replaced with a complex regional policy that will cover the whole territory of Croatia and will also help developed regions to become more competitive and be able to withstand pressures from the strong competition of the single market (when Croatia becomes a member of the EU).

No institutional framework for the implementation of regional development exists in Croatia. Only a few counties have a special agency for regional development. The Ministry of Sea, Tourism, Transport and Development is responsible at the national level, but a problem appears at the regional level, for every region (county) has its own bodies for the implementation of regional development.

Croatia is characterised by fiscal centralization, since, in spite of the partial decentralization carried out, no adequate distribution of responsibilities and fiscal capacities among bodies of local self-government and administration and the central state exists. Regional governments are still much too dependent on the central government, and too little responsive to the requirements of their own populations; this is a situation that certainly needs rectifying. At the moment between 6 and 9% of non-earmarked budgetary funds have been decentralised, while in the coming phase these figures should be increased to 20-25%, the intention being to reach an ultimate degree of decentralisation of between 50-70% of budgetary funds (National Competitiveness Council, 2004).

The European Local Self-Government Charter says that local authorities, acting within the limits of the law, should be able to regu-

late and manage public affairs under their own responsibility in the interests of the local population. Local authorities should be closest to the citizens (Council of Europe, 1985).

Croatia ratified the European Local Self-Government Charter and adopted a number of its provisions in 1997. The first phase of the Government's programme of decentralization began in July of 2001 with amendments to a number of laws, including the financing, organization and election of representative bodies of local and regional government, and the government bound itself to bring its legislation on local self-government into accord with European standards. Local authorities were given the right to regulate and manage public affairs in their own area of competence in the interests of the local population. Responsibility for the provision of public services was delegated to the authorities closest to the citizens, a higher level being considered only when the co-ordination or discharge of duties was impossible or less efficient at the level immediately below.

Economic differences in Croatia are analysed in Table 7 (Annex). There are major disparities in the way individual counties account for percentages of GDP (the City of Zagreb and the Primorje-Gorski kotar County accounted for the largest proportions), of exports (the City of Zagreb and Istria County were the leaders here), and in imports (City of Zagreb and Zagreb County). The City of Zagreb and the County of Istria also had the highest employment rates and the lowest unemployment rates. These two counties are the most developed regions in Croatia, as illustrated in the data of Table 7. Thus it is interesting to know how one of these two counties uses EU aid. On the other hand, there are a many counties that have employment rates lower than the Croatia average, and very high unemployment rates; and they are faced with very deep structural problems.

This analysis shows that Croatia is in this phase falling behind in the development of regional policy, which makes the utilization of funds from the SFs and CF more difficult since it requires properly elaborated strategies with detailed goals and the problems of regional development set out. The solutions of these problems have to be in a qualitative realization of the project "Strategy and Strengthening Capacity for Regional Development" started in October 2003 (technical support is given by the CARDS programme, and the coordinator is the Ministry of the Sea, Tourism, Transport and Development) with the following special aims: defining the national strategy for regional development, and a legislative framework for regional policy. A documentation basis is the prerequisite

264

for being involved in programmes of regional policy that will be created by the accession of Croatia to the EU.

## European Union funding in Croatia

Croatia is not yet a member of the EU so it cannot have access to SFs and CF at this stage. The EU offered a new programme of aid to the Western Balkan countries called CARDS in 2000, as a part of the Stabilisation and Association Agreement (SAA)<sup>x</sup>. Its basic purpose is to support reforms and the building of institutions necessary to implement SAA obligations.<sup>xi</sup> High priority is accorded to regional development, as summarised in two principal goals: to reduce developmental imbalances, in particular promoting the prospects for sustainable development of the war-affected areas, rural areas and islands, and decentralisation, territorial reorganisation and strengthening of local authorities.

*Table 8 European Union assistance to Croatia 1991-2003 (in millions of euro)\**

Programmes	1991-2003
OBNOVA/CARDS	244.2
ECHO humanitarian aid	292.3
Media	3.4
Democracy & Human Rights	5.2
Specific actions	5.2
Total	550.3

\* Commitments because data about payments were not available.

Source: European Commission (2002a).

The aid to Croatia was directed towards relief work during the period 1991-1995, and reconstruction and refugee-return from 1996 to 1999. Between 1991 and 2000, 65% of the received aid was directed to relief projects. This means that only around 128 million euros were focused on restructuring the economy. This is a relatively small amount when compared to that received by the CEEC. EU assistance in 2002-2004 is focused on: democratic stabilisation, economic and social development, justice and home affairs; assistance for public administration reform and implementation of the SAA, environment and natural resources. There are a large number of projects available to Croatia (European Commission, 2001) and they can help Croatia to develop necessary institutional and economic framework in accordance with EU

standards. Croatia might obtain through these projects some ideas about the reform of institutions and the legislative system and how to achieve it, how to improve the functioning of market economy and so on.<sup>xiii</sup>

**Box 2 How to get access to information on funds from the CARDS programme?**

The simplest method is by searching the Internet, especially the web pages of EUROPEAID [<http://europa.eu.int/comm/europaid/cgi/frame12.pl/right>], which describe projects offered by the EU per various assistance programmes. On the left hand side is a menu with the following categories: programmes (CARDS), project status (forecasted, open, closed), project type (services, works, supplies, grants), region and/or country. Search results by given parameters can be obtained by clicking on the "Submit Query" button. After entering the request, all relevant, detailed information concerning applications for the specific project are displayed. It is worth mentioning that the Global Forecast is published at the beginning of each year, from which information is available on which projects were forecasted for which country per particular programme. This makes the preparations for proposing a particular project much easier.

Also, the web pages of the Delegation of European Commission to the Croatia can be viewed at [[http://www.delhrv.cec.eu.int/en/item2/topic\\_5.htm](http://www.delhrv.cec.eu.int/en/item2/topic_5.htm)], which encompasses all calls for proposals in which Croatia can participate.

There is also the monthly booklet "EU Funding Opportunities in Brief", which contains information about environmental and energy-related funding opportunities, public tenders, conferences and training courses in Europe that could be interesting to professionals from Croatia [<http://www.eucenter.org/registration.php>].

Croatia became a candidate for full membership in the EU in June 2004, and the EU adopted a pre-accession strategy for Croatia in October 2004; now the EU is providing more funds for Croatia so that the country can more easily execute and conclude the various and numerous reforms required for membership in the EU. Croatia has the opportunity to have access to the PHARE, ISPA and SAPARD programmes. For the period 2004-2006 it was provided with access to a

total amount of 245 million euros through these three programmes.

Although Croatia is not eligible to use funds from SFs by the “territoriality principle” (MEI, 2004), an exception was found through various forms of cooperation of Croatian regions with the regions of full EU member states. In this system, member states regions use funds from SFs while the regions of non-member countries must secure their own funds for participation in such projects. These projects were submitted and approved within CI – Interreg III that consists of three strands:

- Strand A: cross-border cooperation – aims to develop cross-border social and economic centres through common development strategies. Croatia enters the part named Interadriatic cooperation (European Commission, 2002b);
- Strand B: trans-national cooperation – involving national, regional and local authorities – aims to promote better integration within the EU through the formation of large groups of European regions. Eleven geographical regions were defined within Interreg IIIB programme and Croatia is in the region Central European, Adriatic, Danube, South-Eastern Space (CADSES);
- Strand C: interregional cooperation – aims to improve the effectiveness of regional development policies and instruments through large-scale information exchange and sharing of experience (networks). The entire European region was administratively divided into four zones: East, West, North and South. Croatia is in the East zone.

From the description of these strands it is obvious that interregional cooperation is a prerequisite for a region from a non-member country to be able to participate in Interreg III. The County of Istria is an example from which it is possible to analyse the opportunities for Croatian counties to take part in Interreg III.

### **County of Istria and European Union regional policy**

Istria is the westernmost Croatian region, and historically and development-wise stands out within Croatia. With respect to its economy, Istria is one of the most developed Croatian regions (Table 7). Since EU assistance was mostly directed to aiding the war-affected regions, it is interesting to analyse the position of Istria (it was not war-

affected) with respect to the ability to obtain funds from EU programmes and to the channelling of these funds.

There are several factors that are important for the participation of a region in the projects of Interreg III:

- Inter-regional cooperation – because in this way it is easier to find partners from the EU member states for submitting a project within the initiatives. Istria signed documents on cooperation with four regions in Italy, one region in Hungary, one in Austria and one in Romania. Currently in preparation and harmonization are certain forms of cooperation with regions of Poland, the Russian Federation, Romania and Italy;
- The inclusion of Istria in the work of the Assembly of European Regions (AER). The County has participated in it since 1994 (a precedent – the first region from a country that at the time was not a member of the Council of Europe). This enabled the County to participate not only in the work of the AER, but also in the programmes: Centurio, Eurodysee, Summer School<sup>xiii</sup>;
- Being informed about the legislative framework relating to mutual cooperation in neighbouring countries<sup>xiv</sup>.

The participation of Istria in various projects of Interreg III and the goals of such participation are shown in Table 9 (Annex), most of the work being done in Strand B. To be able to answer the questions: what did Istria obtain through participation in Interreg III, where have problems appeared, how can these problems be solved – one project, Common Strategy Network for Spatial Development and Implementation (CONSPACE), is chosen for detailed analysis<sup>xv</sup>.

Istria was able to include itself in the process of preparing project proposals because the county administrators were well educated, they were well informed about the EU and the possibilities of getting access to EU funds. Some of the employees have been educated in the area of European studies. Istria has wide-ranging cooperation with other regional entities in the neighbouring countries. Thus the officials knew where to look for an opportunity to have Istria involved in different projects. The very important fact is that Istria was not affected by the war, so it did not face the same problems almost all the other counties did. Istria has consistently wanted to move ahead and it has opened the door (shown the way) to other counties in participation in Community Initiatives. Other counties may want to learn from the Istria

experience because the county has achieved significant results. The most important is the willingness and desire to do and develop some common project in cooperation with other regional entities from abroad. All local authorities must understand that the EU wants local government units to show that they are able to cooperate with each other. Only in this way can they have access to the limited Community Initiatives funds.

### **Box 3 Common Strategy Network for Spatial Development and Implementation**

Discussions on project proposals began in Ljubljana in 2002. The project was approved on April 1, 2003 and has been ongoing for 36 months. The participating regions come from: Italy, Austria, Slovenia and Hungary. Croatia is represented by the County of Istria, County of Primorje-Gorski kotar and the Ministry of Environmental Protection, Physical Planning and Construction. The project was divided into six work packages. Istria participates in three packages: Transnational management; Harmonisation of tools, data and procedures and Transnational strategy-regional development. The first two work packages collect existing data into one database, whilst the third work package should determine a mutual strategy of urban development with goals and monitoring indicators.

The interest of Istria in participation in this project is in the introduction to strategies for urban development in the EU member states, in order to determine where we stand, and in which direction local and national urban development strategy should go. Participation in this and similar projects provides experience for later access to SFs and CF. Partners from the EU member states are not familiar with Croatian legislation and structure from the point of view of responsibilities for the creation of urban development plans nor with the structure of urban development. Therefore, through this project, they have a chance to learn about these issues and, based on their own experiences, suggest certain changes in Croatian system.

Istria County has met the project's obligations without problems. The obligations relate to providing various data on urban development in order to create a mutual database. There are no problems in cooperation with regions. However, there is a problem of a vertical nature between the County of Istria and the competent Ministry, which, in spite of the signed agreement, did not take part

seriously in the project and does not provide information from its field. The picture is even worse when it is apparent that the information does not need to be collected but already exists in the statistics and should only be processed and sent out in order to help in the creation of a complete database of the regions and countries participating in the project. For that reason, the leader of the project at the regional level was forced to do a double job and send data for local and national levels. The package proposal projected that the Croatia should lead Work Package 2, yet, due to insufficient cooperation, this part of the project was assigned to Slovenia.

Meetings within each work package are held every six months. Financial reports are being submitted, although Croatia does not utilize the EU funds. Istria covers the expenses of participation in meetings and provides for a part of the project leader's pay. Therefore, Istria is gaining nothing in a financial sense – on the contrary, it must invest its own resources. Yet, it still chooses to participate in this project since the urban planning is a genuine problem for Croatia, and especially, for its coastal areas.

Istria's expectations from participation in different projects are: training of employees in participation in international projects (introduction to the methodology of neighbouring regions and countries, development of common methodology, specialization in technical communication with experts within the EU) but also in opening up possibilities for joining other Interreg projects of the A and C strands and other possible funds of the EU (CARDS programme, for instance).

Extensive financial resources for the development of this region cannot be expected in this phase. However, it is important to enter the system of EU financing because every day (now that Croatia has become a candidate for accession to the EU) there should be more and more possibilities for obtaining funds. Thus, officials on the national and regional levels should be prepared for this and submit calls for projects in a timely manner, and use funds made available by the EU. Croatia should not repeat the experience of the CEEC, in which the utilization of the total mass was relatively small (Table 4). This means that part of the planned resources remained unused due to lack of ideas and innovations. For these reasons Croatian officials should already start to learn how to submit calls for projects, participate with other regions from the Western Balkan area (where Croatia was classified by the EU) and with regions of the EU-15.



## CONCLUSIONS AND RECOMMENDATIONS

Croatia is a country with a GDP lower than 75% of the EU average, and it is facing structural problems. Once it becomes an EU member, Croatia would be classified in the group of beneficiaries of SFs and CF. However, as it is presently only a candidate, Croatia can have access only to funds from the CARDS programme and financial means from CI – Interreg III. From the beginning of next year the programmes PHARE, ISPA and SAPARD will be also open to Croatia. The problems in the possibilities of the utilisation of EU assistance are:

- The current legislative framework in Croatia does not contain a single act capable of systematically addressing problems in regional development for the entire national territory. Regional policy is segmented and oriented only towards the less developed and war-affected regions. Problems of the institutional framework for the implementation of regional development exist.
- Although the Fund for regional development does exist, it has so far only been through support given to regional development projects from the budget, and has not followed up the participation of Croatian regions in EU projects. In the future it should have one of the key roles as the central institution in Croatia through which programmes of EU aid can be effectuated.
- The experience of Istria shows that regional and national authorities are not sufficiently well coordinated in cooperation with other regions. The national authority is not sufficiently included in the implementation of project obligations, the result being that a bad image of Croatia is produced.

It appears that at the macro level we are not ready to use the opportunities that are opened up through participation in programmes and projects of the EU for stimulating regional development. The case of Istria has shown that a lot can be done even in the current phase and that we can participate in projects, even though Croatia is not an EU member. This case should be instructive for other counties in Croatia. The employees of Istria county went through various kinds of training about the basics of the EU and also about the ways in which it is possible to participate in different projects. The County has very good con-

nections and qualitative cooperation with regions from some EU member countries and this is a good prerequisite for obtaining access to the EU funds.

Participation in projects is the result of county efforts. They should not expect that the national government will participate in EU programs and projects and that it will indirectly include them in projects. Every region has to play a very active role in competition for participation in CARDS and also in CI – Interreg III. The prerequisite is that counties should establish international cooperation with equivalent local government units from EU member states and should also have qualified public servants capable of meeting the demands of the project. Based on a thorough analysis, the following recommendations for national and regional level can be made:

- The passing of a National Development Plan as a long-term indicative implementing document of the Strategy for Economic Development. In the process of preparation of this Plan experts, scientists and institutes from different areas should be involved. This will be the basis for the negotiations on the financial allocations from the SFs and CF when Croatia becomes a full member of the EU.
- Definition of a national strategy of regional development that will be relevant to all Croatian regions. The earlier mentioned programme “Strategy and Strengthening Capacity for Regional Development” aims to define this strategy (it also involves different persons who deal with the problems of regional development, and the coordinator is the Ministry of the Sea, Tourism, Transport and Development).
- The establishment of regional development agencies to cooperate in the development of regions, manage programmes, and participate in their realization. This is part of the area of responsibility of the counties<sup>xvi</sup>.
- The education of Croatian officials concerning the various opportunities for EU aid and the methods of obtaining access to these funds (Ministry for European Integration organizes a special training programme county employees)<sup>xvii</sup>.
- Developing inter-regional cooperation and partnerships and hence being able to submit mutual projects (at the county level).
- Monitoring what is happening in the neighbourhood, staying informed (at the national level: Ministry for Foreign Affairs and Ministry for European Integration, and the counties at the regional level).

Although these recommendations might sound like major steps, this is the way Croatia has to go if it wants to reach the goal qualitatively: to achieve higher levels of welfare and higher standard of living for all its citizens. Therefore it would be very worthwhile regarding the necessary reforms (here only a few key examples have been listed) in the light of measures that will positively affect Croatian economic development, and not merely as an obligation that is, at the moment, being indirectly imposed by the EU.

## Annex

Table 7 Comparison of economic indicators of Croatian counties

County of	Share in population in 2001		Share in GDP in 2001		Export in 2003		Import in 2003		Export/import *100		Employment in 2002		Unemployment in 2002	
	%	in 2001	%	in 2001	mill \$	%	mill \$	%	%	000 persons	rate in %	000 persons	rate in %	
Zagreb	7.0		4.7		149.0	2.4	940.4	6.6	15.9	58.9	29.1	20.7	26.0	
Krapina-Zagorje	3.2		2.5		225.2	3.6	247.6	1.7	91.2	32.6	36.3	9.0	21.6	
Sisak-Moslavina	4.2		3.3		371.5	6.0	406.9	2.8	91.5	38.2	33.3	21.4	36.0	
Karlovac	3.2		2.6		94.0	1.8	166.3	1.2	67.3	32.3	37.3	16.6	33.9	
Varaždin	4.2		4.0		306.8	5.9	510.7	3.6	71.9	49.9	42.2	12.5	20.0	
Koprivnica-Križevci	2.8		2.5		128.2	2.5	192.2	1.4	81.6	28.4	36.2	9.4	24.8	
Bjelovar-Bilogora	3.0		2.4		54.6	1.1	128.6	0.9	53.9	26.6	32.2	14.6	35.5	
Primorje-Gorski kotar	6.9		9.0		230.0	3.8	637.9	4.5	37.2	101.5	50.4	21.6	17.6	
Lika-Senj	1.2		1.0		3.4	0.1	7.9	0.1	70.2	10.0	32.7	4.4	30.2	
Virovitica-Podravina	2.1		1.9		69.2	1.8	49.9	0.4	224.0	18.5	32.1	10.9	37.1	
Požega-Slavonia	1.9		1.6		54.9	1.2	49.0	0.3	146.0	17.7	34.0	7.6	30.0	
Brod-Posavina	4.0		2.8		56.8	1.0	104.2	0.7	60.7	32.9	30.2	20.0	37.9	
Zadar	3.7		2.8		105.0	1.7	173.0	1.2	61.6	34.7	34.3	16.5	32.3	
Osijek-Baranja	7.4		7.2		419.2	6.8	307.1	2.2	136.0	77.3	36.7	37.4	32.6	
Šibenik-Knin	2.5		1.8		54.2	0.9	96.4	0.7	56.6	23.3	34.6	14.3	38.0	
Vukovar-Syrmium	4.6		3.2		88.2	1.4	99.3	0.7	88.3	33.1	25.8	23.9	42.0	
Split-Dalmatia	10.4		8.6		557.7	9.0	907.5	6.4	61.3	107.1	36.1	49.3	31.5	
Istria	4.7		5.6		745.4	12.0	775.2	5.5	96.4	71.2	52.6	10.0	12.3	
Dubrovnik-Neretva	2.8		2.7		16.8	0.3	75.8	0.5	22.0	31.6	41.3	10.8	25.4	
Medimurje	2.7		2.3		168.4	2.7	246.1	1.7	68.7	31.5	41.1	8.3	20.9	
Zagreb	17.6		27.5		2,010.7	33.0	7,709.4	54.0	26.1	315.1	61.5	50.4	13.8	
Total	100.0		100.0		6,186.6	100.0	14,209.0	100.0	43.6	1,172.6	41.5	389.7	25.0	

Source: CBS, 2004; Data refer to employment, unemployment, GDP from Regio.hr

Unemployment rates are calculated: number of unemployed persons/number of employees+unemployed; so it is not comparable with ILO statistics;

Employment rates are calculated as ratio of number of employees and labour force (men aged 15-64, women aged 15-59).

Coverage of imports by exports is calculated as  $\frac{\text{export}}{\text{import}} * 100$ ; if the result is bigger than 100, a county has a positive trade balance, and if it is below 100, a county has a trade deficit.

Table 9 Participation of the County of Istria in Community Initiatives

Programmes	Areas	Goals
Strand A Cross-border Programme Italy-Eastern Adriatic Countries	coastal area of Italy, the entire Croatia, Bosnia-Herzegovina, Serbia and Montenegro, Albania	Contribution to the formation of an Adriatic Euroregion: a homogenous territorial and maritime space because the countries of this area, with different levels of gravity, present problems and opportunities of similar advantage. Through this particular programme, Croatia can establish cross-border cooperation with Italy, and indirectly with Bosnia-Herzegovina, Serbia and Montenegro, and Albania.
Strand B L.O.T.O. – Landscape Opportunities for Territorial Organization	9 participants, the leading partner is the Lombardy Region (Italy)	Development and improvement of methodology and methods of protection, improvement and development of landscape, promotion and presentation of networking among institutions in charge of landscape planning. Increasing awareness of and sensitivity to landscape values. Participation should provide evaluation of currently utilized methods in landscape evaluation at the national level and studies already made on Istria, especially in relation to European Convention on Landscape, to which Croatia is signatory and ratification of which is expected in the near future.
CONSPACE – Common Strategy Network for Spatial Development and Implementation	9 participants, the leading partner is the Carinthia Region (Austria)	Realization of mutual trans-national development strategy of regions based on mutual experiences; the expectations of Istria: introduction to methodology which will be used in regional planning in neighbouring regions and countries, development of mutual methodologies in regional planning
I-LOG – Industrial Logistic; Logistic and inter-modal transportation for sustaining small and medium enter- prises development	23 participants, the leading partner is the Marche Region (Italy)	Assist transport operators through new instruments of information technology, and assist SME in reducing transport costs and increase of SME competition.
ADRI.FISH – Promoting of a sus- tainable FISHERY in Northern ADRIatic Sea	6 participants, the leading partner is the Veneto Region (Italy)	To improve organization of fishing activities and SME communication, stimulate partnerships among entrepreneurs and innovations of information technology.
Strand C ECOTOURISM – Places and Traditions	the leading partner is Provincia di Abruzzo	–

Source: County of Istria, 2004

- i *The European Regional Development Fund (ERDF) finances infrastructure, job-creation investments, local development projects and provides aid for small firms; The European Social Fund (ESF) promotes the return of the unemployed and disadvantaged groups to the work force, mainly by financing training measures and systems of recruitment assistance; The Financial Instrument for Fisheries Guidance (FIFG) helps adapt and modernize the fishing industry; The "Guidance" Section of the European Agricultural Guidance and Guarantee Fund (EAGGF – Guidance) finances rural development measures and provides aid for farmers, mainly in regions lagging in development; it also supports rural development under the Common Agricultural Policy in all other areas of the EU.*
- ii *The projects were at the beginning financed by the system of national quotas, which resulted in some less developed regions within one developed country receiving more funds than more underdeveloped regions within less developed countries. This led to the need for the ERDF reform (the system quota/non-quota established in 1979, and the EU defined priorities which would be financed from funds for regional development while preparing for functioning of the single European market in 1989 and then it moved to a programming approach). Goals/priorities were defined for the periods: 1989-1993, 1994-1999, 2000-2006 (McDonald, F. & Dearden, S., 1999, 225).*
- iii *From theory to practice, [http://europa.eu.int/comm/regional-policy/intro/regions7\\_en.htm](http://europa.eu.int/comm/regional-policy/intro/regions7_en.htm).*
- iv *It is interesting to observe the geographical lineup of regions that are the candidates for Objective 1: from the total of around 50 regions (in some countries Objective 1 refers only to a part of a region), 14 regions are in Greece (the entire country), 10 regions in Spain, 6 regions in Italy and Portugal, 5 regions in Germany, 4 regions each in the United Kingdom and France, 3 regions each in Ireland, Finland and Sweden, and 1 region in Austria (EC, 2002c).*
- v *The PHARE programme was initiated in 1989. At the beginning, the funds were directed into projects of infrastructure, private entrepreneurship development, education, specialization and research, environmental protection and nuclear safety, and the restructuring of agriculture.*
- vi *The ISPA programme was initiated in 1999 to provide aid to candidate countries in adjusting to EU standards in the sectors of transport and environmental protection, <http://europa.eu.int/comm/enlargement/pas/ispa.htm>.*
- vii *SAPARD was created in 1999. In order to obtain funds from these programmes, a country must submit several strategic documents (preliminary development plan for PHARE, ISPA strategy of environmental and transport investments, SAPARD-related seven year rural development plan and national development plan) and only those projects which fall into one of the measures defined in the strategies can compete for the assistance. Projects have to be in line with the commitments that country bound itself to in the negotiation process. A coherent structure for managing the assistance has to have been established. Finally, the smooth implementation of programmes and projects and the control of their quality is assured through ongoing monitoring and evaluation (Government of Slovenia, 2003).*
- viii *Following accession, the ERDF and ESF will take charge of the interventions made by PHARE, while the CF will take charge of those by ISPA, and the EAGGF – Guidance those of SAPARD.*
- ix *This Conception was prepared by Economic Institute Zagreb on the initiative of Ministry of Economy.*
- x *Western Balkans: Croatia, Bosnia and Herzegovina, Macedonia, Serbia and Montenegro and Albania.*

- x* Croatia will, in addition, benefit from other measures under the regional programme (the European Initiative for Democracy and Human Rights, Life Third Countries, Youth Programme-Third Countries Co-operation, Regional Cooperation in Mine Action in South-East Europe etc.). Croatia can use funds from the Tempus programme, established for institutions and organizations in the process of reforming higher education. Its goal is to form co-operation among universities in the CEE and the EU.
- xii* Public Administration Reform Project (EC, 2002a) – Public Administration Reform is an integral part of the SAA, since administrative capacity in the state administration must be sufficient to develop and implement new legislation and policies required by the SAA. The project is focused on three specific objectives: strengthening and modernising the current civil service regime through improved legislation and procedures for human resource management; improvement of the organisation, functioning and coherence of central civil service management systems; capacity building for delivery of training programmes for civil servants.
- xiii* Centurio – with the purpose of professional specialization of personnel working in local self-government and management; Eurodysee-exchange of youth between regions which enables them to obtain professional experience (3 to 6 months); Summer School-congress tourism.
- xiv* Law no. 84 of the Republic of Italy (passed on March 21, 2001), refers to Italian participation in the stabilization, reconstruction and development of countries in the Balkan region. Together with partners from Italy, Istria became a candidate for two projects: CONNECT and FISH.LOG. These are basic initiatives which lead towards the realization of a policy for the mutual management of the Northern Adriatic.
- xv* Information was provided by Ms. Latinka Janjanin, project leader for the County of Istria.
- xvi* Several regional development agencies already exist, for instance Istrian Development Agency (IDA), Local Economic Development Agency for Western Slavonia (LEDA).
- xvii* For instance the programme of training on the EU ABC, programme of training for lecturers for county employees, aiming to inform them and involve them in various forms of cooperation with the EU.

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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.

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 was the preparation of the associated countries for EU accession. It was based on the principles of respect for human rights, democracy, the rule of law and the market economy. Europe Agreements were signed with ten countries: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

CANDIDATE COUNTRIES – Bulgaria, Romania, Turkey and Croatia have submitted requests for membership in the EU, which have been

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\* Glossaries from the European Union (<http://europa.eu.int/scadplus/leg/en/cig/-g4000.htm>) and the Ministry of European Integration of the Republic of Croatia (<http://www.mei.hr/default.asp?ru=137&akcija=>) were used.

accepted, and their accession negotiations with the EU are now in various stages.

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, Serbia and Montenegro 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 securing 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 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 became a full member on March 1 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.

CONSTITUTION TREATY – on October 29, 2004 the prime ministers and foreign ministers of the 25 member states of the EU signed the

European Constitution, the fundamental law of the Union, while representatives of the candidate countries, Bulgaria, Romania and Turkey, signed only the final part of the Constitution. The process of ratification of the European Constitution has to be completed in a period of two years. It is intended to replace all existing EU Treaties with a single consolidated document.

**COPENHAGEN 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 to decide when it will receive new members.

**COUNCIL OF EUROPE** – an intergovernmental organisation based in Strasbourg 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. → EUROPEAN COUNCIL, COUNCIL OF THE EUROPEAN UNION

**COUNCIL OF MINISTERS – COUNCIL OF THE EUROPEAN UNION** (often cited as the Council or the Council of Ministers in the texts) – the most important legislative body of the EU. Since it is composed of the ministers of the national governments of the member states, national interests are represented in this institution at the European level. Today, the Council of Members shares its legislative role in many areas with the European Parliament. This is the result of the democratisation process of European integration, in which the role of the European Parliament, the only democratically elected body at the European level, is becoming constantly stronger. Although in many areas it no longer makes independent decisions, in the Union, no decision of a legislative nature can be made without the involvement of the

Council of Ministers. The composition of the Council varies according to the area on which the decisions are being made. When this is, for example, the Common Agricultural Policy, the agriculture ministers of the member states sit in the Council, when it is to do with the arrangement of the trans-European railway networks, the ministers of transport or other appropriate departments of the national government will take their seats. Within the institutional triangle of the Union (EC, EU and European Parliament), the Council of the European Union represents the member states. → EUROPEAN COUNCIL, COUNCIL OF EUROPE

ECOFIN (Economic and Financial Affairs) – Council of Ministers of the EU for economic and financial affairs.

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 process of creating the EMU unfolded in three phases, the last of which was the foundation of the European Central Bank, the determination of exchange rates and the introduction of the single currency. The third phase of the EMU started in 11 members, and Greece joined two years later. The common currency was not adopted by three member states: Denmark, Sweden and the UK.

EURO, the – single currency that on January 1, 1999 was accepted by 11 members of the EU (Austria, Belgium, Finland, France, Ireland, Italy, Luxembourg, Holland, Germany, Portugal and Spain), the ultimate aim being the total abolition of national currencies. Denmark and the UK used the right to remain outside the “euro zone” (according to the Maastricht Treaty), while Greece and Sweden did not formally satisfy the convergence criteria by the time mentioned. Greece, having met these criteria, entered the euro zone in 2001. The introduction of the euro as the single currency in the EU is the third phase of Economic and Monetary Union. The total replacement of national currencies in the euro zone with euro bills and coins was carried out at the end of February 2002.

## EUROPE AGREEMENTS → ASSOCIATION AGREEMENTS

EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, EBRD – was founded in 1991, the aim being to help the former communist in their transformation into market economies. In 27 countries, through investment into mostly private firms, either on its own or with partners, the Bank promotes structural and sectoral reforms, market competition, privatisation and entrepreneurship, the strengthening of financial institutions and legal systems, the necessary development of infrastructure for private sector development and the adoption of good corporate governance, including awareness of environmental protection. The Republic of Croatia became a member of the European Bank for Reconstruction and Development on April 15 1993. The Bank's headquarters is in London.

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, EC – a political body that represents the interests of the EU as a whole. It proposes laws, policies and programmes, and is responsible for the implementation of the decisions of Parliament and the Council. Until the accession of the new members, it was 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. In the new mandate 2004-2009 the Commission is composed of 25 members. 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 EU) as a common

284

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 unofficial EU communications all these three communities are referred to for short as the Community.

EUROPEAN COUNCIL – refers to the meeting of heads of state or heads of governments of EU member states with the President of the EC. Meetings are held four times a year, in order to discuss important EU issues → COUNCIL OF EUROPE, COUNCIL OF THE EUROPEAN UNION.

EUROPEAN ECONOMIC AREA, EEA – created in 1992 by an agreement signed by the then 12 member states of the European Commission and 6 members of 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 the EU and 3 member states of EFTA (Iceland, Liechtenstein, Norway). In the EEA 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 launched in 1994 and is based on four pillars of employment policy: employability, entrepreneurship, adaptability and equal opportunities.

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 25 states of the EU. EFTA was founded by the Stockholm Convention of 1960 as an alternative to the EEC as it then was.

EUROPEAN INVESTMENT BANK, EIB – is a financial institution of the EU that was organised in 1957 by the Treaty of Rome. The objective of this institution is to contribute to the integration process and in general to the objectives of the EU, through the provision of

long-term financial resources for certain capital projects in the Union and other countries worldwide.

EUROPEAN MONETARY SYSTEM, EMS – 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 NEIGHBOURHOOD POLICY – a new policy calling on neighbours to the east and south of the EU to take part in the peace, stability and prosperity, its objective being to create a ring of friends around the borders of the new, enlarged EU.

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 new Constitutional Treaty says that no matter how small a country is, it has the right to a minimum of six members in Parliament. National quotas for each new member are laid down in the Accession Treaties. The maximum number of members in the Parliament is also laid down by the Founding Treaty. The EP currently has 732 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 five waves of enlargement (1973, Denmark, Ireland and the UK; 1981, Greece; 1986, Portugal and Spain; 1995, Austria, Finland and Sweden and the ten new members in



2004), the EU today has 25 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 (ECSC), the European Economic Community (EEC) and the European Atomic Energy Community (Euratom); 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.

**EXCESSIVE DEFICIT PROCEDURE** – member states are obligated to avoid excessive budgetary deficits, i.e., they must maintain budgetary discipline, respecting two criteria: the budgetary deficit must not amount to a sum that is more than 3% of GDP, and the public debt must not exceed a sum equivalent to 60% of GDP. If these values are exceeded in some country, what is called an excessive deficit procedure is activated at the level of the Union. The procedure establishes the level of the deficit, measures to cope with it, and possible financial penalties. The Stability and Growth Pact stipulates the procedure if this is an excessive deficit.

**EXCHANGE RATE MECHANISM, ERM** – the germ of the Economic and Monetary Union. This was 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.

**FINANCIAL PERSPECTIVE** – the basic objective of this is to lay down seven-year political priorities and the curbing of overall growth in budgetary expenditure in the EU. It is the fruit of agreements between the European Parliament, the Council and the Commission, and determines the maximum amount and structure of expenditures anticipated. So far three such agreements have been made: the 1988-1992 Financial Perspective (the first Delors package), the 1993-1999

Financial Perspective (the second Delors package) and the 2000-2006 Financial Perspective, which is the foundation for the Agenda 2000 financial package. → AGENDA 2000

INSTRUMENT FOR STRUCTURAL POLICIES FOR PRE-ACCESSION, ISPA – was officially launched on April 1 2000, the aim being to provide help to the EU candidate states in their preparations in the area of transport and environmental protection. For the 2000-2006 period, the Programme will have 1.04 billion euros (according to 1999 prices) available, and in the European Commission it is the Regional Policy Directorate-General that is charged with overseeing this programme. The main priorities of the programme are the preparation of the candidate states in the areas of education concerning EU policies and procedures, assistance in reaching EU environmental protection standards, and expansion and linkage with trans-European transport networks. → PRE-ACCESSION AID

INTERREG III – an initiative of the Community, the aim of it being to enhance economic and social cohesion in the EU through the encouragement of the balanced development of the European continent via cross-border, trans-border and inter-regional collaboration. The initial idea of the Interreg initiative, adopted in 1990, was to prepare the border areas of member states for a community with no internal borders. Member states of the EU that take part in Interreg III can use for this purpose the resources of the European Regional Development Fund for this purpose. States that are not EU members must finance their own participation in this initiative from their own resources and/or if the EC approves, from the EU assistance programme. At the EU level, within the context of the European Commission, the Regional Policy Directorate-General is charged with Interreg III affairs.

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.

NEW MEMBER STATES – Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia completed their negotiations and from being candidate countries became member states of the EU on May 1 2004.

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 of today). In time it spread to the countries of CEE (apart from 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 was the main financial instrument of the pre-accession strategy of the ten countries of CEE that submitted applications for EU membership. The objectives of the PHARE for the 2000-2006 period are mainly directed to building up institutions and the financing of investments in candidate countries. → PRE-ACCESSION AID

PRE-ACCESSION AID – as a form of aid for preparation of the countries of Central and Eastern Europe for membership in the EU, the EU founded three programmes for the 2000-2006 period: PHARE, ISPA and SAPARD, the pre-accession programmes as they are called. The PHARE programme concentrates on the building up of institutions, participation in Community programmes, economic and social cohesion and industrial restructuring. The SAPARD programme deals with the modernisation of agriculture and rural development, while ISPA supports infrastructure projects in the area of transport and environmental protection.

PRE-ACCESSION STRATEGY – a form of assistance that was supposed to facilitate the economic and political transition in the countries

of CEE. The European Council adopted it in 1994, and it was 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.

SAPARD (The Special Accession Programme for Agriculture and Rural Development) – a special EU accession programme for agricultural and rural development meant for candidate countries. The objective of the programme is to assist candidate countries to overcome problems of structural adjustments in their farm sectors and rural areas and to afford assistance in the implementation of the *acquis* in the area of the Common Agricultural Policy, and the whole of the relevant legislation. The programme was launched at the beginning of 2000, and the candidate states have the right to make use of it until they join the Union. → PRE-ACCESSION AID

SINGLE MARKET, INTERNAL MARKET – the conceptual framework for the unification of the economic area in the EU through the realisation of the four freedoms, as they are called – freedom of movement of people, goods, services and capital without any internal borders. Today the concept “internal market” is used more, and this is how the same meaning is defined in the European Union Treaty, i.e., the abolition of all internal barriers to the functioning of the four freedoms. The Single European Act of 1986 was the first to make essential amendments to the Treaty of Rome (which paved the way for the creation of a common market) necessary for the establishment of a single market, and at the beginning of 1993 the internal market of the EU started functioning.

SOCIAL POLICY PROTOCOL – adopted in 1991 in Maastricht, and signed by 11 EU countries (the UK did not sign it). It was subsequently signed by Austria, Finland and Sweden. In it, the signatory countries express their intention of increasing employment, improving living and working conditions and so on. This area was later included within the purview of the Amsterdam Treaty, and the Social Policy Protocol ceased to exist as a separate entity.

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 services 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 Economic and Monetary Union, which started on January 1 1999. Its objective is to ensure 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 budgetary 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 regional initiatives. In Croatia, it is the Ministry of Foreign Affairs that is charged with the coordination of all activities related to the Pact.

**STRUCTURAL FUNDS, COHESION FUND** – these constitute a part of the structural policy of the Union, the objective of which is to reduce the gap in development between the rich and the poor regions and member states of the EU and to promote economic and social equality. The four structural funds are: The European Regional Development Fund (ERDF), The European Social Fund (ESF), The European Agricultural Guidance and Guarantee Fund (EAGGF) and The Financial Instrument for Fisheries Guidance (FIFG). The Cohesion Fund was set up in 1993 in order additionally to reinforce structural policy. It is meant for cohesion countries the per capita GDP of which is less than 90% of the Union average, and its aim is to finance envi-

ronmental protection and transport infrastructure. They make about one third of the EU budget.

**EUROPEAN INNOVATION SCOREBOARD** – contains a number of standardised indicators of innovation activities. The EC adopted the first such document in 2001.

**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, founded in 1951 by the Benelux countries, Germany, France and Italy) and defined the objectives for the creation of a common market to ensure the free movement of people, goods, services and capital were laid down. When the Maastricht Treaty (the European Union Treaty) came into force, the European Economic Community was renamed the European Community.

**TREATY ON THE EUROPEAN UNION, EU TREATY** – a treaty that set up the EU 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	Description
CEFTA	<a href="http://www.cefta.org/">http://www.cefta.org/</a>	Site devoted to the Central European Free Trade Agreement
European Commission in the Republic of Croatia	<a href="http://www.delhrv.cec.eu.int/">http://www.delhrv.cec.eu.int/</a>	Information about EU activities in Croatia
EFTA	<a href="http://www.efta.int/">http://www.efta.int/</a>	Site of the European Free Trade Association
Economical and Social Committee of the EU	<a href="http://www.esc.eu.int/">http://www.esc.eu.int/</a>	Information about its initiatives and EU policies in general
EU Business	<a href="http://www.eubusiness.com/">http://www.eubusiness.com/</a>	News from Europe and the EU
EU in the USA	<a href="http://www.eurunion.org/">http://www.eurunion.org/</a>	Publications, information about the EU in the USA; list of web sites of EU member states
EU Observer	<a href="http://www.euobserver.com/">http://www.euobserver.com/</a>	EU site with latest news from Europe
European Investment Bank	<a href="http://eib.eu.int/">http://eib.eu.int/</a>	Site of the financing institution of the EU
European Central Bank	<a href="http://www.ecb.int/">http://www.ecb.int/</a>	Site of the central bank for Europe's single currency, the euro
European Union	<a href="http://europa.eu.int">http://europa.eu.int</a> <a href="http://europa.eu.int/comm/enlargement/enlargement.htm">http://europa.eu.int/comm/enlargement/enlargement.htm</a>	Official site of the EU EU enlargement site
Statistical Office of the EU	<a href="http://europa.eu.int/comm/eurostat/">http://europa.eu.int/comm/eurostat/</a>	A guide to the EU statistical office
Council of the EU	<a href="http://ue.eu.int/">http://ue.eu.int/</a>	Site of the main decision-making body of the EU
European Commission	<a href="http://europa.eu.int/comm/index_en.htm">http://europa.eu.int/comm/index_en.htm</a> <a href="http://europa.eu.int/comm/external_relations/">http://europa.eu.int/comm/external_relations/</a>	Official site of the European Commission Information about the European Commission's contribution to the EU's work abroad

	<a href="http://europa.eu.int/comm/regional_policy/index_en.htm">http://europa.eu.int/comm/regional_policy/index_en.htm</a>	site about improving regional competitiveness, increasing and improving employment and balancing development in urban and rural areas
	<a href="http://europa.eu.int/comm/enlargement/docs/newsletter/weekly_arch.htm">http://europa.eu.int/comm/enlargement/docs/newsletter/weekly_arch.htm</a>	Newsletter of the European Commission general administration for enlargement
European Parliament	<a href="http://www.europarl.eu.int/">http://www.europarl.eu.int/</a>	Tasks; members; announcements
European Movement	<a href="http://www.europeanmovement.org/">http://www.europeanmovement.org/</a>	
Ministry of European Integration	<a href="http://www.mei.hr">http://www.mei.hr</a>	Information on the EU, EU programmes and aspects of Croatia's approach to European integration
	<a href="http://www.mei.hr/default.asp?ru=137&amp;sid=&amp;jezik=1">http://www.mei.hr/default.asp?ru=137&amp;sid=&amp;jezik=1</a>	European integration glossary
	<a href="http://www.mei.hr/download/2002/06/05/E-H_Glosar-final.pdf">http://www.mei.hr/download/2002/06/05/E-H_Glosar-final.pdf</a>	English-Croatian glossary of the SAA
NYU School of Law – Jean Monnet Center	<a href="http://www.jeanmonnetprogram.org/calendar/index.html">http://www.jeanmonnetprogram.org/calendar/index.html</a>	Annual calendar of conferences and seminars related to European integration
Stability Pact	<a href="http://www.stabilitypact.org/">http://www.stabilitypact.org/</a>	Site of Stability Pact for South Eastern Europe
PUMA	<a href="http://www.oecd.org/puma/">http://www.oecd.org/puma/</a>	OECD site; information related to the area of administration and the organization of public sector
SIGMA	<a href="http://www.sigmaweb.org">http://www.sigmaweb.org</a>	OECD and EU site concerning state administration and public sector reform in the countries of CEE
The Court of Justice of the European Communities	<a href="http://curia.eu.int/">http://curia.eu.int/</a>	
European Court of Auditors	<a href="http://www.eca.eu.int/">http://www.eca.eu.int/</a>	Site of the institution that examines the accounts of the Union's revenues and expenditure



Fund for Regional Development of the Republic of Croatia EU center	<a href="http://www.fondrr.hr/">http://www.fondrr.hr/</a> <a href="http://www.eucenter.org/">http://www.eucenter.org/</a>	Practical assistance to institutions of higher education, municipalities and SMEs across Europe about EU funding opportunities
Regio.hr Eurostat	<a href="http://www.regio-hr.com/">http://www.regio-hr.com/</a> <a href="http://epp.eurostat.ec.eu.int/">http://epp.eurostat.ec.eu.int/</a>	Provides the EU with a high-quality statistical information service
Dialogue with Citizens Employment, Social Affairs and Equal Opportunities	<a href="http://citizens.eu.int">http://citizens.eu.int</a> <a href="http://www.europa.eu.int/comm/employment_social/">http://www.europa.eu.int/comm/employment_social/</a>	Practical information on citizens' rights and opportunities in the EU Information on the social policy agenda, employment, European Social Fund, working conditions and working organization, inclusive society, gender equality
International Labour Organization United Nations Economic Commission for Europe	<a href="http://www.ilo.org">http://www.ilo.org</a> <a href="http://www.unece.org">http://www.unece.org</a>	Provides a forum for communication among States; supplies statistics and economic and environmental analysis
OECD Central Bureau of Statistics of the Republic of Croatia Croatian Employment Service	<a href="http://www.oecd.org/">http://www.oecd.org/</a> <a href="http://www.dzs.hr/">http://www.dzs.hr/</a> <a href="http://www.hzz.hr/">http://www.hzz.hr/</a>	Information on job placement services, active labour market policy measures as a follow-up of EU employment guidelines, labour market information and published materials relevant to promoting employment
Government of the Republic of Croatia	<a href="http://www.vlada.hr/">http://www.vlada.hr/</a>	

## Index

### A

accession costs . . . . . 8-9  
administration . . . . . 5-7

### C

coefficient of trade  
openness . . . . . 66-71  
Cohesion Fund  
of the EU . . . . . 256-257  
consumer protection . . . . . 9-10  
costs of accession . . . . . 8-9  
criteria of the EU . . . . . 32-33  
economic . . . . . 37-38, 63-66  
Croatia  
accession costs . . . . . 8-9  
administration . . . . . 5-7  
coefficient of trade  
openness . . . . . 66-71, 72  
consumer protection . . . . . 9-10  
costs of accession . . . . . 8-9  
economic indicators  
per county . . . . . 273  
economy . . . . . 7-9  
education . . . . . 14-15, 109-128  
effects of EU  
enlargement . . . . . 10-12, 31-60,  
36-48  
energy . . . . . 5-6  
environmental protection . . . 10  
equality between men  
and women . . . . . 9  
ethnic minorities . . . . . 9  
EU aid . . . . . 264-266  
foreign trade . . . . . 12-13, 31-60,  
37-38, 61-84  
free movement of labour . . 13-14  
gender equality . . . . . 9  
housing policy . . . . . 204-206  
illegal construction . . . 210-211  
innovation . . . . . 15-16  
innovation policy . . . . . 15-16,  
132-134, 138-139

innovation potential . . . 129-159  
labour force . . . . . 109-128  
labour mobility . . 13-14, 97-100  
legal system . . . . . 6-7  
movement of capital . . 185-228,  
88-196  
movement of labour . . . 85-107  
legal framework . . . . . 96-97  
negotiations with the EU . . . 25  
non-governmental sector . . . . 9  
protection of ethnic minorities . . 9  
public administration . . . . . 5-7  
real estate market . . . . . 18-20,  
185-228, 196-207  
macroeconomic  
effects . . . . . 214-216  
regional policy . . . . . 21-23,  
249-278, 261-264  
social dialogue . . . . . 16-18,  
161-184, 174-175  
social inclusion . . . . . 161-184  
social policy . . . . . 16-18,  
161-184, 171-178  
CARDS . . . . . 175-177  
social protection . . . . . 16-18  
social reform . . . . . 173-174  
spatial planning . . . . . 20-21,  
229-247, 237-243  
speed of accession  
to the EU . . . . . 48-52  
structural reforms . . . . . 25  
tax burden . . . . . 7-8  
tourism . . . . . 18-20, 185-228,  
207-214  
satellite balance . . 208, 220-221  
trade . . . . . 61-84  
trade integration . . 61-84, 71-78  
trade openness  
coefficient . . . . . 66-71

296

virtual membership . . . 25, 51-52

**D**

Denmark

real estate . . . . . 193

**E**

economic indicators

per county . . . . . 273

economy . . . . . 7-9

education . . . . . 14-15, 109-128,  
142-146

in the EU . . . . . 112-119

effects of EU

enlargement . . . 10-12, 31-60, 36-48

economic . . . . . 42-47

energy . . . . . 5-6

enlargement of the EU . . . 10-12,  
31-60

economic effects . . . . . 42-47

process . . . . . 34-36

enlargement process

in the EU . . . . . 34-36

environmental protection . . . . . 10

equality between men

and women . . . . . 9

ethnic minorities . . . . . 9

EU

aid to Croatia . . . . . 264-266

Cohesion Fund . . . . . 256-257

criteria . . . . . 32-33

economic . . . . . 37-38, 63-66

education . . . . . 112-119

enlargement . . . . . 31-60

economic effects . . . . . 42-47

process . . . . . 34-36

innovation policy . . . . . 131-132

movement of labour . . . . . 85-107

regional policy . . . . . 251-255

Croatia . . . . . 261-269

new members . . . . . 257-261

requirements

for membership . . . . . 32-36

related to space . . . . . 235-237

social dialogue . . . . . 169-170

social issues . . . . . 163-170

social policy

open coordination

model . . . . . 165-169

reform . . . . . 170-171

spatial development . . . 232-235

Structural Funds . . . . . 251-255

allocation of resources . . . 255-257

financing . . . . . 253

instruments and objectives . . 254

objectives of

financing . . . . . 251-252

virtual membership . . . . . 51-52

**F**foreign trade . . . . . 12-13, 31-60,  
37-38, 61-84

free movement of labour . . 13-14

**G**

gender equality . . . . . 9

**H**

housing policy . . . . . 204-206

**I**

illegal construction . . . . . 210-211

innovation . . . . . 15-16, 149-151

innovation policy . . . . . 15-16,  
132-134, 138-139

in the EU . . . . . 131-132

innovation potential . . . . . 129-159

in CEE . . . . . 136-138

Istria . . . . . 266-269

Interreg III . . . . . 274

**L**

labour force . . . . . 109-128

labour mobility . . . 13-14, 97-100

legal system . . . . . 6-7

**M**

Malta

- real estate . . . . . 195-196  
 minorities . . . . . 9  
 movement of capital . . . 185-228,  
*188-196*  
 movement of labour . . . . 85-107  
 Austria . . . . . 92  
 Bulgaria . . . . . 95-96  
 Hungary . . . . . 91-92  
 new members . . . . . 93-95  
 Romania . . . . . 95-96  
 Slovenia . . . . . 91  
 transitional arrangements . . 92-96
- N**  
 negotiations with the EU . . . . 25  
 new members  
 movement of labour . . . . 93-95  
 real estate market . . . . 194-196  
 regional policy . . . . . 257-261  
 non-governmental sector . . . . . 9
- P**  
 protection of ethnic minorities . . 9  
 public administration . . . . . 5-7
- R**  
 real estate . . . . . 18-20, 185-228,  
*196-207*  
 Denmark . . . . . 193  
 macroeconomic effects . . 214-216  
 Malta . . . . . 195-196  
 new members . . . . . 194-196  
 regional policy  
 in Croatia . . . . . 21-23, 249-278,  
*261-264*  
 in the EU . . . . . 251-255  
 in the new members . . . 257-261  
 requirements for membership  
 in the EU . . . . . 32-36  
 research  
 and development . . . . . 146-148
- S**  
 SAP  
 social issues . . . . . 171-173
- social dialogue . . 16-18, 161-184,  
*174-175*  
 in the EU . . . . . 169-170  
 Social Europe . . . . . 163-170  
 social inclusion . . . . . 161-184  
 social issues in the SAP . . 171-173  
 social policy . . . . 16-18, 161-184,  
*171-178*  
 EU model of open  
 coordination . . . . . 165-169  
 social policy reform  
 in the EU . . . . . 170-171  
 social protection . . . . . 16-18  
 social reform . . . . . 173-174  
 spatial development  
 EU requirements . . . . . 235-237  
 in the EU . . . . . 232-235  
 spatial planning . . . . . 20-21,  
*229-247, 237-243*
- speed of accession  
 to the EU . . . . . 48-52
- Structural Funds  
 of the EU . . . . . 251-255  
 allocation of resources . . 255-257  
 financing . . . . . 253  
 instruments and objectives . . 254  
 objectives of financing . . 251-252  
 structural reforms . . . . . 25
- T**  
 tax burden . . . . . 7-8  
 tourism . . 18-20, 185-228, *207-214*  
 satellite balance . . 208, 220-221  
 trade . . . . . 61-84  
 integration . . 61-84, 66-71, *71-78*  
 openness coefficient . . . . 66-71  
 transitional arrangements for  
 movement of labour . . . . . 92-96
- V**  
 virtual membership  
 in the EU . . . . . 25, 51-52

