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Opinion on Croatia's Application for Membership of the European Union

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A. INTRODUCTION

a) Preface

Application for Membership

Croatia presented its application for Membership of the European Union on 21 February 2003 and the Council of Ministers decided on 14 April 2003 to implement the procedure laid down in Art. 49 of the Treaty on the European Union, which states: "Any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union. It shall address its application to the Council, which shall act unanimously after consulting the Commission and after receiving the assent of the European Parliament, which shall act by an absolute majority of its component members."

Art. 6.1 states "The Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States."

That is the legal framework within which the Commission submits the present Opinion.

Context of the Opinion

The Croatian application for membership is part of an historic process, in which the Western Balkan countries are overcoming the political crisis of their region and orienting themselves to join the area of peace, stability and prosperity created by the Union. In the "Thessaloniki Agenda for the Western Balkans" adopted by the European Council of June 2003, the EU stressed "*that the pace of further movement of the Western Balkans countries towards the EU lies in their own hands and will depend on each country's performance in implementing reforms, thus respecting the criteria set by the Copenhagen European Council of 1993 and the Stabilisation and Association Process conditionality*"

The European Council in Copenhagen in June 1993 concluded that:

"The associated countries in Central and Eastern Europe that so desire shall become members of the Union. Accession will take place as soon as a country is able to assume the obligations of membership by satisfying the economic and political conditions.

Membership requires:

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

The Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries".

This declaration spelled out the political and economic criteria for examining the accession requests of the applicant countries.

The European Council in Madrid in December 1995 referred to the need, "to create the conditions for the gradual, harmonious integration of the application countries, particularly through: the development of the market economy, the adjustment of their administrative structure, the creation of a stable economic and monetary environment".

The Stabilisation and Association Process conditionalities were defined by the Council on 29 April 1997 and included co-operation with the International Criminal Tribunal for the Former Yugoslavia (ICTY) and Regional co-operation. These conditions are a fundamental element of the Stabilisation and Association process and are integrated into the Stabilisation and Association Agreement signed with Croatia.

In its Opinion, therefore, the Commission analyses the Croatian application on the basis of Croatia's capacity to take on the obligations of meeting the criteria set by the Copenhagen European Council of 1993 criteria and the conditions set for the Stabilisation and Association process, notably the conditions defined by the Council in its Conclusions of 29 April 1997

The Contents of the Opinion

The structure of the Opinion takes account of the conclusions of the European Council in Copenhagen. It:

- describes the relations up to now between Croatia and the Union, particularly in the framework of the existing agreement;
- analyses the situation in respect of the political conditions mentioned by the European Council (democracy, rule of law, human rights, protection of minorities) including the fulfilment of the Stabilisation and Association Process conditionalities;
- assesses Croatia's situation and prospects in respect of the economic conditions mentioned by the European Council (market economy, capacity to cope with competitive pressure);
- addresses the question of Croatia's capacity to adopt the obligations of membership, that is the *acquis* of the Union as expressed in the Treaty, the secondary legislation, and the policies of the Union;
- makes finally a general evaluation of Croatia's situation and prospects in respect of the conditions for membership of the Union, and a recommendation concerning accession negotiations.

In assessing Croatia in respect of the economic criteria and its capacity to assume the *acquis*, the Commission has included a prospective assessment; it has attempted to evaluate the progress which could reasonably be expected on the part of Croatia in the coming years, before accession, taking account of the fact that the *acquis* itself will continue to develop. For this purpose, and without prejudging the actual date of accession, the Opinion is based on a medium-term time horizon of approximately five years.

During the preparation of the Opinion, the Commission has obtained a wealth of information on Croatia's situation from the Croatian authorities, and has utilised many other sources of information, including the member states, international organisations (Council of Europe, OSCE, UNHCR, ICTY, Stability Pact, IMF, World Bank, EBRD, EIB etc.) and NGOs.

b) Relations between the EU and Croatia

Amid increasing tension within the Socialist Federal Republic of Yugoslavia, Croatia declared independence on 25 June 1991. This was suspended for three months and confirmed on 8 October 1991 (by Parliament's decision on the abrogation of the state-legal ties with the former SFRY). An armed conflict, resulting in the displacement of ethnic groups, subsequently broke out and parts of the country were occupied by the local Serb rebels and Yugoslav People's Army (JNA). The EU recognised Croatia as a sovereign State in January 1992 and in May 1992 the country was admitted to the United Nations. In May and August 1995, Operations "Flash" and "Storm" enabled Croatian forces to take control of all occupied territories with the exception of Croatian Danube Region (Eastern Slavonia) which remained under UN protection. Croatia became party to the Dayton/Paris Peace Agreement of December 1995 which recognises the international borders of Bosnia and Herzegovina and confirms the right of all refugees to return to their homes. The Erdut Agreement of November 1995 provided for the peaceful reintegration of Eastern Slavonia into Croatia which was completed in January 1998. However, during this period progress in areas such as democratisation, respect of human rights, including minority rights, and the rule of law was insufficient to justify an upgrading of relations with the EU

The parliamentary elections in January 2000 and the election of Stjepan Mesic as President of the Republic in February 2000 marked a turning point in relations between the EU and Croatia. The new Croatian leadership immediately showed determination to entrench democratic values and principles and made rapid and significant progress on the main political outstanding questions, notably the respect of human rights, including minority rights, democratisation of the media, full compliance with the Dayton/Erdut Agreements, cooperation with ICTY and improved relations with neighbouring countries

This commitment was reflected in a rapid development of relations with the European Union. In May 2000, the Commission adopted a "Feasibility Report"¹ proposing the opening of negotiations for a "Stabilisation and Association Agreement (SAA)". Since November 2000 Croatia benefits from the autonomous trade measures granted unilaterally by the European Union to the countries of the Stabilisation and Association Process. The Stabilisation and Association Agreement was signed in October 2001 and an Interim Agreement (IA) is in force since March 2002.

A resolution adopted in December 2002 by all political parties in the Croatian parliament defined Croatia's accession to the EU as a strategic national goal and asked the Government to submit an application for EU membership. This application was submitted by the Government in February 2003. The cross-party consensus on the political goal of EU membership was also maintained after the change of Government following the November 2003 parliamentary elections. Membership of the European Union and NATO, relations with neighbours, developing economic diplomacy, and changing Croatia's international image are the five priorities of the foreign policy announced by the new Government.

¹ COM (2000) 311 of 24 May 2000

Contractual Relations

The Stabilisation and Association Agreement (SAA) between the European Union and Croatia was initialled on 14 May 2001 and signed on 29 October 2001. The ratification process of the Stabilisation and Association Agreement has not yet been completed. Once it enters into force, the SAA will be the legal framework for relations with the European Union for the entire period prior to a future accession of Croatia. It will provide a framework for political dialogue and enhanced regional co-operation, promotes the expansion of trade and economic relations between the parties and establishes a basis for Community technical and financial assistance. The institutional framework of the SAA will provide a mechanism for implementation, management and monitoring all areas of relations. Subcommittees will examine questions at technical level. The Stabilisation and Association Committee will provide for discussions at senior officials level and is aimed at finding solutions to problems arising under the SAA. The Stabilisation and Association Council will examine the overall status of and perspective for relations and provides the opportunity to review Croatia's progress in the Stabilisation and Association Process.

Pending the entry into force of the SAA, an Interim Agreement has been applied provisionally from 1 January 2002 and entered into force on 1 March 2002. The Interim Agreement applies the provisions of the SAA related to trade in goods as well as those on competition, and intellectual, industrial and commercial property rights. The Agreement establishes a Free Trade Area between the parties in agreement with relevant WTO provisions. It puts the EU's far-reaching autonomous trade measures, in force since November 2000, on a contractual basis (with the exception of the "entry price system" for certain fruit and vegetables, which was removed under the autonomous trade measures). These measures grant Croatia free access to the EU-market for virtually all products, with preferential tariff quotas for wine, baby beef and certain fishery products. The Interim Agreement is asymmetric in favour of Croatia, which is to gradually liberalise its import trade from the EU over a transition period ending on 1st January 2007. By that date, Croatia will have eliminated all tariffs on imports of industrial goods and on several agricultural and fishery products, whilst maintaining duties and tariff quotas for certain more sensitive agricultural and fisheries products.

Two meetings of the Interim Committee were held in April 2002 and April 2003. A system of five subcommittees has started to work, which serve as useful fora for technical discussions of all issues linked to the implementation of the Agreement and to the legal approximation process. In general, Croatia has properly implemented the Interim Agreement and it has contributed to the smooth functioning of the various joint institutions. However, during the first two years of application, there have been certain problems in implementation in the field of agricultural trade.

An additional protocol to the Interim Agreement / SAA regarding trade in wine and spirits and reciprocal recognition, protection and control of wine names and of designations for spirits and aromatised drinks is in force since March 2002.

An Agreement on trade in textile products between the European Community and the Republic of Croatia has been applied since January 2001.

Negotiations on a protocol adapting the Stabilisation and Association Agreement and the Interim Agreement to take into account the upcoming accession of ten new Member States to

the Union have been concluded. While the Interim Agreement will apply to the enlarged EU as from 1st May 2004, the protocol is necessary to allow the ten new Member States to become formally party to the SAA. Technical adaptations are also necessary in various areas, including to adapt the trade preferences in the SAA/IA for agricultural products, both basic and processed, as well as fishery products, with a view to avoid disrupting traditional trade between Croatia and the enlarged Union. It is recalled that the Free Trade Agreements between the new Member States and Croatia will be terminated on 1st May 2004, when the new Member States apply the Common Commercial Policy.

The Ministry for European Integration coordinates the implementation of the SAA in a highly efficient and professional way. The Government has set up European Integration coordinators in all state administration bodies as well as a number of inter-ministerial working groups for the harmonisation of legislation.

In October 2001 Croatia adopted an Implementation Plan for the SAA for planning and monitoring legislative and non-legislative measures linked to obligations under the SAA. Croatia produces regular reports on the execution of this plan. In December 2002 Croatia adopted the first “National Programme for the Integration of the Republic of Croatia into the EU”. This strategic document set out Croatia’s ambitions and tasks regarding political and economic criteria, the harmonisation of the Croatian legal framework with the *acquis*, the enhancing of administrative capacity and an information strategy for the Croatian public. The programme foresaw the adoption of 83 laws and pieces of secondary legislation in order to advance the harmonisation of the Croatian legal framework in 13 chapters of the *acquis*. In general, these measures were adopted within the envisaged timeframe. A second National Programme was adopted in January 2004 comprising all chapters of the *acquis*.

Croatia has worked intensively towards aligning its legislation with the *acquis communautaire* and numerous important legislative texts have been adopted by Parliament, in particular during 2003. However, in general, the establishment of the necessary administrative structures and more generally the strengthening of administrative and judicial capacities have not developed at the same pace, thereby putting at risk the effective implementation and enforcement of the new legislation. Croatia needs to give particular priority to administrative and judicial capacity building and fully integrate this dimension into its National Programmes.

Trade Relations

The EU is Croatia's main trading partner. Between 1998 and 2002 trade between the EU and Croatia increased substantially. EU imports from Croatia increased by 38%, from €1.8 billion in 1998 to €2.5 billion in 2002. EU exports to Croatia grew by 47% over the same period, from €4.4 billion to €6.5 billion. The respective evolution of imports and exports led to a worsening of Croatia's trade deficit with the EU, which leapt by more than 50%, from €2.6 billion in 1998 to €4 billion in 2002. Furthermore, Croatia has a trade deficit of approximately € 1 billion with the countries acceding to the EU in May 2004. While Croatian exports represent about 23% of GDP, approximately 54% of its external trade was with the EU in 2002. This figure rises to nearly 70% when considering trade with the countries acceding to the EU in May 2004. Croatia’s share of EU’s external trade stood at 0.45% in 2002.

In 2002 Croatia’s exports to the EU consisted mainly of textiles (22% of the total) and machinery and electrical equipment (18% of the total). The EU’s exports to Croatia consisted

mainly of machinery and electrical equipment (25% of the total), vehicles, aircraft, vessels and associate transport equipment (17% of the total) and chemicals (10% of the total).

Croatia is a member of the World Trade Organisation and the Central Europe Free Trade Agreement. It is active in the Trade Working Group under the Stability Pact for South East Europe. In this context, Croatia has negotiated a network of bilateral free trade agreements with all its neighbouring countries.

Community Assistance

Overall, between 1991 and 2003 Croatia received €550 million of EU assistance. Between 1991 and 2000, this assistance was focused on emergency support through the European Commission's Humanitarian Aid Office (ECHO) and the Obnova programme. The EU consolidated its assistance in 2000 under the Community Programme for Assistance, Reconstruction, Development and Stabilisation (CARDS), at the same time as launching the Stabilisation and Association process (SAp). In 2001, €60 million was allocated to Croatia under the CARDS programme.

In accordance with the CARDS regulation, a Country Strategy Paper, defining the main areas for co-operation for the period 2002-2006, was adopted in December 2001. The associated multi-annual indicative programme (MIP) sets out in more detail priorities for the period 2002-2004. In the framework of the CARDS National Programmes, the total financial allocation for the period 2001 and 2004 amounts to €257 million for the following five main priorities: democratic stabilisation, economic and social development, justice and home affairs, administrative capacity building, and environment and natural resources.

Croatia is directly involved in CARDS programming, including discussions on current strategies and agreement on the MIP. These discussions involve not only the National Aid Coordinator, but also the relevant Ministries, potential beneficiaries, international financial institutions and the non-governmental sector.

Croatia is also a beneficiary of the CARDS Regional Programme, the European Initiative for Democracy and Human Rights, Life Third Countries, the Youth Programme - Third Countries Co-operation, Regional Co-operation in Mine Action in South East Europe and a number of other specialized programs.

Implementation of CARDS assistance has been slow but there are signs of improvement due to increased absorption capacity in the Croatian administration. Since January 2002, the EC Delegation in Zagreb is responsible for the management of assistance and implementation has speeded up considerably. In order to use pre-accession funds effectively, Croatia will need to develop the necessary administrative capacity.

Several twinning projects (Border Police, Customs, Statistical Agency, and Asylum) are ongoing and more are planned in the sectors of integrated border management (IBM), agriculture, and the judiciary.

The Croatian administration needs to continue its efforts to meet agreed project conditionality (e.g. policy decisions, establishment and strengthening of institutions, allocation of human and financial resources) but some progress can be noted.

A Commission-EU Member State co-ordination mechanism on assistance has been in place since 2001, to maximise the impact of CARDS and member states' bilateral aid.

Effective co-operation also exists with other donors. Since 1993, the World Bank has supported 21 projects totalling US\$1.064 million and provided a number of grants to the amount of US\$20 million. Lending is focused on investment in infrastructure, health, agriculture and forestry, enterprise and financial sector reform, capital market development, as well as judicial and pension system reform. Since 1994, the European Bank for Reconstruction and Development (EBRD) has made investments totalling €1.325 million, including over €300 million in 2002. The focus of investment is the corporate sector (pharmaceutical, food, cement, and communications), financial sector and municipal infrastructure. In 2002, the European Investment Bank (EIB) has provided loans to the amount of €130 million for regional development (transport and communications infrastructure), economic and social cohesion, and environmental protection.

B. CRITERIA FOR MEMBERSHIP

1. POLITICAL CRITERIA

The European Council in Copenhagen in 1993 decided on a number of “political” criteria for accession to be met by applicant countries. A country must have achieved “stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities”. In the case of the Western Balkans the conditions defined by the Stabilisation and Association Process are also a fundamental element of the EU policy, which will be assessed in this Opinion.

In the meantime, through the entry into force of the Treaty of Amsterdam in May 1999, the political criteria defined at Copenhagen have been essentially enshrined as a constitutional principle in the Treaty on European Union. Article 6(1) of the consolidated Treaty on European Union reads: "*The Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms and the rule of law.*" Accordingly, Article 49 of the consolidated Treaty stipulates that "*Any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union.*" These principles were emphasised in the Charter of Fundamental Rights of the European Union, that was proclaimed at the Nice European Council in December 2000.

In carrying out the assessment required in this connection, the European Commission has drawn on a number of sources of information: answers given by the Croatian authorities to the questionnaire sent to them by Commission in July 2003, bilateral follow-up meetings, discussion with Member States’ embassies, assessments by international organisations (including Council of Europe, OSCE, UNHCR, Stability Pact), reports produced by international and local non-governmental organisations, minority representatives, etc.

The following assessment includes a systematic examination of the main ways in which the public authorities are organised and operate, and the steps they have taken to protect fundamental rights. It does not confine itself to a formal description but seeks to assess the extent to which democracy and the rule of law actually operate. This assessment relates to the situation by the end of February 2004. It does not examine in detail any changes which have taken place in the past or which may come about in the future, though it generally takes account of any stated intention to reform a particular sector.

1.1. Democracy and the Rule of Law

Parliamentary democracy in Croatia was established following the spring 1990 elections. The new Constitution was adopted in December 1990, on the eve of the outbreak of the war in the former Yugoslavia. Croatia gained independence in 1991; since then a number of constitutional changes have taken place. The constitutional changes in 2000 and 2001 were introduced in order to abolish the Upper House of the Parliament and strengthen the role of Parliament and Government *vis-à-vis* the President of the Republic. The 3 January 2000 elections resulted in the end of the 11 years rule of the Croatian Democratic Union (HDZ), President Tudjman’s party. During the period 2000-2003, Croatia, under a coalition of (initially) 6 parties, made significant achievements in areas related to the rule of law and democracy. The Constitutional system was respected and institutions functioned normally.

The *President of the Republic* is elected by direct universal suffrage for a renewable five-year term of office. He calls elections for the Parliament, calls referenda, gives the mandate to

form the Government to the person who enjoys the confidence of the majority of the members of Parliament, and performs other duties specified by the Constitution. In co-operation with the Government, the President also takes part in the formulation and implementation of foreign policy. The President is the Supreme Commander of the armed forces, appoints and relieves military commanders of duty. Under precisely defined circumstances, the President may dissolve the Parliament if the Government does not pass a vote of confidence, or if the State Budget is not adopted within 120 days from the date it was proposed. The President is responsible for possible violations of the Constitution that he may commit while performing his presidential duties. The procedure for determination of his responsibility is initiated on proposal by a two-thirds majority of all members of parliament. The Constitutional Court rules on such question with a two-thirds majority of its judges.

The current President of the Republic is Mr. Stjepan Mesić, elected in February 2000 in two rounds; the next elections are to be held by February 2005.

The *Constitution* was adopted on 22 December 1990 after the first multi-party parliamentary elections held in the spring of 1990. It was amended in 1997, 2000 and 2001 by a two-thirds majority vote of all the members of the parliament as foreseen by the Constitution. It established Croatia as a parliamentary democracy. However, the operation of institutions in Croatia encountered a number of difficulties in the first decade after independence. The revision of the Constitution in November 2000 moved Croatia from a semi-presidential system to a full parliamentary system. This has resulted in a positive reshaping of the relationship and the balance of power between the President, the Parliament and the Government.

1.1.1. The Parliament

Role and Structure

The Parliament (Sabor), is made up of a single chamber, the House of Representatives. This has, according to the Constitution, a minimum of 100 and a maximum of 160 representatives elected for a four-year term. The electoral law provides for proportional representation through party lists in 10 electoral constituencies. Eight seats in the Parliament are reserved for minorities who form the 11th constituency. The Serb minority has three guaranteed seats, the Italian and Hungarian one each, the Slovaks and Czechs are entitled to one representative, while other minorities are divided into two groups of which each is entitled to one representative. The Croatian Diaspora, which constitutes the 12th electoral unit, is also entitled to Parliamentary representation. The number of elected Diaspora representatives depends on the so called “non-fixed” quota, i.e. the number of members elected from Diaspora constituency is calculated by dividing the total number of votes cast abroad by the average number of votes necessary to secure a mandate in Croatia's ten constituencies.

The Parliament can be dissolved by itself or by decision of the President of the Republic if the Government loses a confidence vote in Parliament or if the State budget is not adopted within 120 days of its proposal by the Government.

Member of parliaments enjoy parliamentary immunities. The Opposition's role and involvement in the working of the country's institutions is recognised. The parliamentary minority is entitled to propose its candidate for the position of the vice-president of the Parliament. Opposition representatives in Parliament are also members of 25 parliamentary committees: 12 are chaired by HDZ and 13 by the other parties.

Croatia has a multiparty system. 94 political parties are registered. There are no obstacles to the establishment of parties, they receive state funding in proportion to the number of seats they obtained at the previous elections.

The Parliament exercises legislative power and shares the right of legislative initiative with the Government. Usually all laws undergo a lengthy parliamentary procedure of three consecutive readings. However, the Constitution allows for an urgent procedure of two readings. Many laws have recently been adopted through the urgent procedure.

One fifth of the parliamentary representatives can initiate the procedure for a vote of confidence in the Government.

The Parliament can call for referenda on proposals for amendments to the Constitution, on any legislative proposal or on any issue considered of importance.

Functioning of the Parliament

The last parliamentary elections were held on 23 November 2003. The Croatian Democratic Union (HDZ), the party of former President Tudjman, won 66 out of 152 seats, including 4 seats of the Diaspora. The new HDZ Government received the support of the Croatian Social Liberal Party (HSLs) and the Democratic Centre (DC) coalition, the Croatian Pensioners Party (HSU), and the minority representatives.

The new Parliament held its constitutive session on 22 December 2003 and the new Government of Prime Minister Ivo Sanader received a vote of confidence on 23 December 2003 (88 MPs voted in favour, 29 MPs against and 14 abstained)

The Croatian Democratic Union (HDZ), which had been in the opposition in the previous legislature (2000-2003) has showed a strong determination to transform itself into a democratic party with a pro-European vocation. However some statements made in the recent past, when HDZ was in opposition, are still a matter of concern for the Commission. It still need to be demonstrated whether all elected members have really distanced themselves from radical nationalism.

Since Croatia became an independent State, parliamentary elections were held in 1992, 1995, 2000 and 2003. There has been an obvious improvement in the electoral process during the last two general elections which were assessed as generally free and fair. Both the last two elections have resulted in the formation of coalition governments.

Parliament functions satisfactorily, its powers are respected and the opposition fulfils its role. Parliament sometimes suffers from the lack of a quorum, which can unduly prolong the legislative process.

1.1.2. The Executive

Role and Structure

The decision on the appointment of the Prime Minister is taken by the President of the Republic, and co-signed by the President of the Parliament, after the Parliament has given a vote of confidence on the Government. Ministers are also approved by Parliament, upon a proposal by the Prime Minister. The Government is answerable to Parliament. The Prime Minister and the members of the Government are jointly responsible for Government decisions, while each minister is responsible for his/her area.

At the request of the Parliament, the Government is obliged to inform the Parliament of its policy, the execution of acts and other regulations and matters within its authority. The institute of interpellation, provided for by the Constitution, governs the accountability of the Government to the Parliament and the matter of confidence in the Prime Minister, individual members of the Government or the Government as a whole. In the period between 1990 – 2004 there have been 9 interpellations.

On the basis of the Constitution, the Government has autonomous regulatory powers that enable it to issue decrees for the implementation of the laws. It can be authorized by parliament to regulate certain issues by decrees apart from those regarding human rights and freedoms, minority rights, electoral system and organisation and functioning of the local and regional self-government. However, these decrees can last no longer than a year. In addition, the Government is authorised to pass decrees with the force of law regarding the existing economic policy that is under the original Parliamentary scope of authority when the Parliament is not in session or during the period in which the Parliament is dissolved due to elections. However, these decrees must be submitted for parliamentary approval as soon as the Parliament convenes.

The Government is responsible for the work of all bodies of the State Administration which includes ministries, State Administration organisations and offices of public administration. Ministries and State Administration organisations are central bodies of the State Administration, but offices of the state administration are also established in the local (regional) self-government units. In addition, for certain tasks, branch-offices can be established at county, municipal or city level.

The structure and tasks of the state administration have been revised and defined by the Law on the Organisation and Scope of the Ministries and State Administrative Organisations adopted on 22 December, which establishes 14 ministries and 5 state administration organisations. A Central State Office for Administration was also created in December 2003, which is not yet fully operational. The Law on Civil Servants and Public Employees governs the terms of employment. The Law on Government regulates the work and authority of the Government while the Law on Obligations and Rights of State Officials regulates state officials' rights and duties.

The Constitution establishes the structure of **local administration**. Units of local self-government are “municipalities” and “cities”. Units of regional self-government are “counties”. 426 Municipalities, 121 Towns and 20 Counties (including the town of Zagreb, which has the status of a County) have been established by law. Local government responsibilities are defined by Local Government Act of 2001 and include responsibilities such as water supply and sewerage, primary health care, pre-school and primary education, etc. Local financing is regulated by the Act on Financing Local Government. It is based mainly on tax sharing and various non-tax revenues. Local self-government collects revenue from own revenue sources (revenue from its own assets, county and municipal taxes, fines, charges and fees), shared taxes (income tax, profit tax, tax on real estate transactions, gambling tax) and grants.

The army and the police are under civilian control. There is an on-going reform of the **army**, which will lead to a significant reduction in the number of military personnel. The army is under the control of Parliament and the executive. The law provides for the civil control of the Secret Services by the Council for Supervision of Secret Services, whose members have been appointed recently.

The **police service** is also being restructured. In April 2003 the Ministry of Interior announced a Reform strategy plan which is still ongoing. Croatia has clearly decided to move from a wartime system to a system compatible with EU standards. Sustained efforts to implement such a significant change are still required, however.

The general **level of security** in Croatia remains satisfactory. There have been only a few ethnically related incidents.

Functioning of the Executive

The Law on Civil Servants and Public Employees of 2001 provides a legal basis for the status of civil servants and other public employees. The Law does not make any distinction between state officials (political appointees) and civil servants, thereby leaving unresolved issues such as status, role and obligations of political personnel in the civil service, tenure of political appointees within the civil service, modalities/procedures for the conversion of the status of political appointees to that of civil servants.

The current number of rulebooks (i.e. internal documents for each Ministry defining job descriptions, number of staff, etc.) and inconsistencies between them, create the conditions for a multitude of civil service management standards. The Law suffers from further deficiencies, especially with regard to a system of promotions, mobility, separation from service and disciplinary measures. The rules governing recruitment and selection of candidates could also be improved. It is an accepted view that salaries of civil servants are too low to attract adequate numbers of young and educated professionals to work in the state administration, especially as that they have to have the same or higher education than those working in other sectors.

Actions and decisions of civil servants, when deciding on individual citizens' rights and obligations, are based on the Law on General Administrative Procedure. Every administrative decision can be appealed to a second-degree administrative body. If appeals are not upheld, there is then recourse to the Administrative Court. However, as established by the decision of the Constitutional Court², regarding civil rights and obligations, the Administrative Court is not a court of full jurisdiction in the terms of the European Court of Human Rights case law, because [see *Paragraph 1.1.3. on Judiciary*].

In addition, recourse can be had to the **Ombudsman**, elected by the Parliament for a term of 8 years. This length of term helps strengthen the independence of the post from political pressure. In the last few years many cases have been brought to his attention. In 2002 he received 1,558 complaints. In 104 of these cases he sent a recommendation to the administration concerned and only 72 complainants succeeded in his/her complaint. The Ombudsman investigates citizens' complaints of bureaucratic abuse both by state authorities and by individual public servants. In addition to investigating individual cases, the Ombudsman studies other matters relevant to the protection of constitutional and legal rights brought to his knowledge from other sources (such as mass media), reporting on irregularities in the work of state administration bodies and agencies. The Ombudsman reports annually to the parliament.

The Standing Orders of the Government of the Republic of Croatia from 2000 provide the legal framework for policy formulation and cover also inter-ministerial consultations. There is

² Decision of Constitutional Court No. U-I-745/1999, of 8 November 2000, Official Gazette 112/00

no single body responsible for providing a coordinated overview of policy to decision-makers. Since there are multiple structures, the policy planning and coordination tends to be rather politicised and fragmented.

The Ministry for European Integration is responsible for coordination with regard to European Integration matters. All the ministries have a network of European coordinators, and specific European Integration units have been established within some ministries.

There is no central training institution for civil servants, or a Government training programme. The reorganisation of the Ministry of Justice, Administration and Local-Self Government, of November 2003 provided for the creation of the Training Centre for Civil Servants under the Ministry of Justice. Following the adoption of the Law on the Organisation and Scope of the Ministries and State Administrative Organisations of 22 December 2003, a Decree was adopted by the Government on 22 January 2004 on the Internal Structure of the Central State Office for Administration. The Decree foresees 11 organisational units, including the Centre for training and education of state employees. Currently the Ministry for European Integration organises EU training for civil servants.

The development of local government is still under way. Decentralisation foreseen in the Government programme 2000-04 has been slower than originally foreseen and should be speeded up. Since July 2001, the reform of local government was implemented at county level and in 32 cities. The following areas were transferred from the state to the county budgets: elementary and secondary education, social care centres and homes, hospital investment maintenance, and to the city budgets: elementary education. Since the beginning of 2002, hospital maintenance, the foundation and financing of social care centres and homes for the elderly and disadvantaged persons have been transferred to counties. The transfer of personnel and salaries in education was never enforced. The financial situation, albeit regulated by the Act on Financing Local Government of local government, should be better clarified.

1.1.3. The Judiciary

Role and Structure

The Croatian judicial system is organised hierarchically in three instances. 122 municipal courts, 114 misdemeanour courts, 12 commercial courts and 21 county courts act as courts of first instance. The county courts also decide on appeals against decisions by municipal courts. Croatia guarantees the right of appeal (county courts, High Misdemeanour Court, High Commercial Court, Supreme Court). The Supreme Court is the highest court in Croatia.

The President of the Supreme Court and the State Attorney are elected by Parliament and appointed by the President of the Republic.

The Administrative Court should ensure judicial protection against final administrative decisions. However, the Constitutional Court ruled in November 2000, that the Administrative Court is not a court of full jurisdiction in accordance with Article 6 (right to fair hearing) of the European Convention of Human Rights, in particular because of its limited ability to establish independently the facts of a case and to hold oral and contradictory hearings.

he Constitutional Court decides on conflicts of interest among the three branches of government and is authorised to assess the conformity of laws with the Constitution and the conformity of by-laws with the Constitution and laws. It is also empowered to decide upon

constitutional petitions submitted by individuals who consider that their constitutional rights have been violated by the final acts of state authorities or bodies of local or regional self-government. The Constitutional Court is facing a constant increase in the number of individual petitions submitted. It is also the competent appellate authority to conduct proceedings regarding decisions on the dismissal or disciplinary responsibility of judges. According to the Croatian system the Constitutional Court is not considered to be part of the judiciary.

The independence of the Croatian judiciary is guaranteed by the Constitution and by the Courts Act. Judges are confirmed in their posts and appointed to a permanent position after serving a five-year probation period. Their permanent status is guaranteed by the Constitution. Judges are appointed by the State Judicial Council on the basis of opinions received from the judicial councils which are formed in each court. The Ministry of Justice examines whether the candidates comply with the formal requirements, while the relevant parliamentary committee and the president of the relevant court can also express their opinion. State attorneys (prosecutors) are appointed by the State Attorney Council following a similar procedure. Both Councils are autonomous and independent bodies. As regards the selection of candidate judges, no competitions are organised. To become a judge, a lawyer has to fulfil two eligibility criteria: first, to pass the bar exam and second, to have a certain number of years of work experience, depending on the category of court he is applying for. According to the Courts Act, judges may not be members of political parties or carry out other activities that may influence their autonomy, impartiality or independence.

Judges enjoy immunity in accordance with the Constitution and the Courts Act. In order to lift the immunity of a judge and to give approval for the institution of criminal proceedings against him, a proposal has to be submitted to the State Judicial Council by the competent State Attorney Office. The State Judicial Council decides on accountability of judges for misconduct or breaches of rules of profession in disciplinary proceedings. However, the evaluation of the performance of judges by the State Judicial Council remains largely theoretical. Apart from one case pending for corruption allegations, there have only been a few decisions of the State Judicial Council in disciplinary proceedings against judges. There is no Code of Ethics binding for all judicial officials. However, the Association of Croatian Judges (a local NGO) has adopted an ethical code for its members.

The tasks of court counsellors and clerks are described in the Rules of Procedure on Internal Organisation of the Judicial Body. Judges have many tasks which could be carried out by clerical staff. In order to relieve judges from administrative tasks, legislative changes were adopted by Parliament in January 2004.

The judicial system is still recovering from a period of high staff turn-over and shortages. Vacancies are gradually being filled with young judges, attorneys and clerical staff but a further overall increase in the number of staff is planned in principle. However, Croatia already has a high number of judges in relation to the number of citizens as compared to EU and acceding countries. There were 1868 judges, 513 State attorneys, 378 court counsellors and 6023 court clerks (2.8 for every magistrate) in late 2003.

The **budget** for the judiciary in 2003 (including prosecutors and the prison system) amounted to €231 million, compared to €192 million in 2002. This amount included €10.2 million for investment in buildings and office equipment, up from €5.5 million in 2002. A further increase of the budget for the judiciary by approximately 10% has been approved for 2004.

Infrastructure and equipment for the judiciary remains a serious problem. Computerisation of commercial courts, the cadastre and land books has only just started, and large investments are needed. While 3300 computers have been delivered in recent years, 2500 more are planned to be delivered in 2004-2005. Courts do not yet have access to data bases of law enforcement agencies. Automation of the court management system should be finalised by 2008. There are no computerised networks yet that would link different courts. Court buildings are mostly old and worn-out and need to be refurbished and/or reconstructed.

The **Centre for Professional Training of Judges and other Judicial Officials** was created in 1999 but became partly operational only in 2003. Although formally it is an autonomous service within the Ministry of Justice and foresees continuous training for judges and prosecutors, in practice the Centre has not yet built up sufficient capacity to cope with its tasks. It has only 4 staff including the Director and no permanent budget. At present, trainers are not selected through a competition and not evaluated on their performance. The Centre urgently needs to elaborate a training strategy, establish a team of trainers and start providing long-term training as well as training events in the regions. While the Centre has organised seminars on an *ad hoc* basis (mainly funded by international donors), e.g. on European Court of Human Rights procedures, case law and other topics, training in EU law has not yet started. The Centre should also establish institutionalised co-operation with the Supreme Court, which is supposed to supervise the training of judges according to the Courts Act. An additional problem is the fact that courts lack budgetary resources for training. Plans to strengthen the Centre or to establish a Judicial Academy should be pursued with vigour.

Functioning of the Judiciary

In the second half of the 1990s, Croatia's judicial system lacked independence and efficiency, and had staff shortages. While considerable improvements have been made and the independence of the judiciary has been established, major challenges remain to be addressed. The main problems are the widespread inefficiency of the judicial system and the amount of time needed to hand down and enforce judgments as well as weaknesses related to the selection and training of judges. Moreover, too many issues are brought before courts that could in principle be decided by other means. All these factors combine to cause a very large backlog of cases. An additional problem is that the courts and parts of the state administration do not always respect or execute in a timely way the decisions of higher courts. Citizens' rights are therefore not yet fully protected by the judiciary in accordance with the provisions of the Constitution.

There is a **backlog** of about 1.38 million cases, indicating serious constraints in the judiciary's ability to handle the work load. In order to shorten court procedures and alleviate the work load in courts a number of measures have been announced recently: while the Codes of Criminal and Civil Procedure have been amended to simplify and speed up procedures, it remains to be seen what the real impact will be. Further steps are needed in this area. In criminal cases, the main investigative authority should move from the courts to the State Attorney's Office. Non-disputed inheritance cases should be processed by public notaries rather than courts. First steps in this direction have been taken with the adoption of the Inheritance Act. The Act on Amendments to the Court Registers Act seeks to simplify, speed up and reduce the cost of the procedure for registration in the Court Register. Finally, the Mediation Act foresees in alternative dispute resolution, but Croatian citizens are not yet familiar with the institute of mediation, so tangible results cannot be expected soon.

The **structural reform** of the Croatian judicial system started with the adoption by the government in November 2002 of a strategic document on the "Reform of the Judicial

System” and an Operational Plan adopted in July 2003. The strategy identified a set of measures addressing a number of structural weaknesses. It included proposals for the establishment of a professional training system, alleviation of the work load in courts and simplification of court proceedings. It foresaw the adoption of new laws, purchase of equipment and filling of judicial vacancies, although the time frame was rather unrealistic. The reform proposed in 2002 did not address the issue of changes to the Courts Act that would enable mobility of judges, provide for obligatory training and link professional achievement to promotion.

In January 2004, the Parliament provided new impetus for the continuation of judicial reform by adopting a package of amendments to the Courts Act. Aimed at reducing the backlog, the amendments envisaged the redistribution of cases from overburdened courts to courts having the same jurisdiction but a smaller case-load, to widen the competences of court counsellors in order to carry out certain procedural actions and thus to relieve judges, and to extend the possibility of transfer of judges, with their consent, from one court to another. In addition, the amendments provided for a detailed description of the obligations of judges and a better evaluation system. The Government has also adopted proposals to entrust execution procedures to enforcement officers vested with public powers. However, this measure requires amendments to the Enforcement Act, which have yet to be adopted by Parliament. In addition, full use should be made of changes to the Civil Procedure Code, in force since December 2003, which introduced time-limits and other measures to prevent abuse of procedural possibilities. The implementation of all these measures will require substantial efforts on the part of the Croatian authorities.

The **enforcement of judgements** in the criminal area is under the authority of execution judges and is regulated separately from the enforcement of other types of judgments referring to different, especially financial, claims. The biggest part of the backlog of cases within the Croatian judiciary is connected with registration cases and the enforcement of civil judgments, especially those imposing financial obligations on debtors or requiring certain types of action from them. Plans to reform the Enforcement Act should therefore be pursued with vigour.

1.1.4. Anti-corruption measures

Croatia has ratified the Criminal and the Civil Law Conventions of the Council of Europe and has adapted national legislation accordingly. Corruption is defined as a criminal offence. Croatia acceded to the Group of States against Corruption (GRECO) in December 2000. The GRECO Plenary meeting addressed sixteen Recommendations to the Croatian authorities in May 2002. These recommendations deal with both legislative and administrative measures. Croatia is due to submit a report on its implementation of the Recommendations to GRECO in the near future.

Croatia is not a Member of the OECD but participates in the working group of non-members and takes an active part in the Anti-Corruption Network (ACN). Preparations for accession to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions are underway.

International reports and surveys indicate that corruption in Croatia continues to be a problem and affects various aspects of society. Despite significant efforts during the past years to intensify the fight against corruption, further action needs to be taken.

At the national level Croatia has adopted and implemented various anti-corruption related laws. Furthermore a comprehensive plan of actions and measures as well as a national anti-corruption programme exist. However, so far no follow-up on the implementation of the national programme has been produced, even though many of the deadlines in the programme had been set for 2001. National legislation has been partly aligned with the provisions of the 1995 Convention on the Protection of the Communities' Financial Interests and its protocols, although further improvements are necessary. Various legal acts, in particular the Act on the Prevention of Conflicts of Interest in Performing Public Duties, contain provisions to prevent conflicts of interest between the private and public sectors.

With the establishment of the Office for the Suppression of Corruption and Organised Crime (USKOK) there is a specialised body to investigate and prosecute corruption. The Office operates as a special unit within the State Attorney's Office. Close co-operation is foreseen with the Office for the Prevention of Money Laundering. However, USKOK is not yet fully operational and its administrative and operational capacity needs to be considerably improved. Training is provided at different levels and via different organisations and programmes.

There are various sources of statistics on corruption. The State Attorney issues an annual report with statistics on corruption cases which is debated in the Croatian Parliament. Furthermore the Ministry of Interior keeps separate statistics on corruption offences and the Croatian Bureau of Statistics collects relevant data from state administration bodies including the State Attorney's Office and USKOK.

Various measures are being taken to upgrade staff capacities, improve working conditions and provide adequate facilities and IT equipment for the courts, the State Attorney's offices and USKOK. However, significant further improvement will be required. In addition, more action should be taken to raise public awareness of corruption as a serious criminal offence.

1.2. Human Rights and the Protection of Minorities

Croatia has put in place a number of legislative provisions to guarantee the respect human rights and the rights of minorities. The Constitution deals with fundamental freedoms and rights. These rights can also be underpinned by certain International conventions, foremost of which is the European Convention for the Protection of Human Rights and its main additional protocols. Taken as a whole, this constitutes - pursuant to Article 6 of the Treaty on European Union - part of the *acquis* any state wishing to join the European Union must first have ratified these texts.

Croatia has been a member of the Council of Europe since 1996, ratified the European Convention for the Protection of Human Rights and the additional protocols 1997. Individuals may take their case to the European Court if they consider that their rights under this Convention have been violated.

Among the other international conventions protecting human rights and minorities, Croatia has ratified the European Convention on the Prevention of Torture, the European Charter for Regional and Minority Languages but has to sign the 1996 European Social Charter. It has ratified the existing key UN conventions in the field of human rights with their Protocols.

In accordance with Article 140 of the Constitution, international Treaties are part of the internal legal order of the Republic of Croatia and apply over ordinary national legislation.

1.2.1. Civil and Political Rights

Access to justice is guaranteed by the Constitution. *Legal aid* is available in criminal cases. In civil cases, only the Bar Association provides free legal aid. Foreigners cannot receive legal aid in civil cases. There is no free legal aid for individuals without citizenship (such as many of the Roma community). The Bar Association set its own fees for legal services. There is no legal aid in civil cases organised by the state or state control over the eligibility criteria for legal aid offered by the Attorney Bar Association. The Law on Court Fees exempts returnees and internal displaced persons (IDPs) from the obligation to pay court fees. The Law on Asylum, however, does not specify how legal assistance will be provided to asylum seekers. The *death penalty* has been abolished and Croatia has signed Protocol 13 to the Convention for the Protection of Human Rights and Fundamental Freedoms concerning the abolition of the death penalty in all circumstances; this entered into force on 1 July 2003. Torture, inhuman and degrading treatments are forbidden by the Constitution. Forced or obligatory labour is not permitted either.

In October 2002, Croatia adopted a National Plan for the Suppression of *Trafficking in Human Beings* in line with international standards. Currently, under the 1997 Criminal Code, trafficking in human beings is only criminalised under Article 175 which penalises slavery with no specific reference to trafficking.³

The Croatian Constitution prohibits all forms of *discrimination* including discrimination on the basis of race. The Criminal Code prescribes criminal responsibility for those who violate the equality of citizens on the basis of race; it provides for criminal liability for those who, on the basis of difference in race, sex, colour of skin, nationality or ethnic origin violate basic human rights and freedoms. There is no specific criminal provision forbidding acts of xenophobia.

Arbitrary arrest is forbidden by the Constitution. Nobody can be arrested or put into custody without a written judicial order. Any arrested person has the right to appeal to the court which decides on the legality of the deprivation of liberty and must be immediately informed of the reasons for the arrest. In addition, the Constitution provides for compensation to be paid to a person unjustly arrested. The length of the pre-trial detention is defined precisely in the law with guarantees for the person deprived of his/her liberty that it is on line with international standards.

The *right to vote* is guaranteed and defined by the Constitution, for all citizens who have reached the age of 18 years. This provision also applies to citizens who are abroad at the time of the elections.

Freedom of association and assembly are guaranteed by the Constitution. The relevant law, which entered into force on 1 January 2002, has been implemented without reported problems. The number of registered Civil Society Organisations in Croatia is rapidly growing and increasingly diversifying. Whilst in 1999, only 15,375 NGOs were registered, the total number had increased to 23,740 by August 2003. In addition 70 foundations, 6 funds and 120 international NGOs are also registered. Throughout the years, the role of NGOs has been

³ The July 2003 amendments to the Criminal Code amended Article 175 bringing it into line with the International Convention that specifically refers to trafficking in human beings. However for formal procedural reasons, the Constitutional Court annulled, on 27 November 2003, the amendments to the Criminal Code adopted by Parliament on 9 July that were due to enter into force on 1 December 2003. The Constitutional Court decided that the amendments had been adopted without the qualified quorum

extremely important in advancing human rights particularly in areas such as refugee issues and election monitoring.

Freedom of expression is guaranteed by the Constitution. Before 2000, overt pressure, harassment, economic extortion and arbitrary prosecutions were practised. The situation has improved considerably since 2000. The media is now to a large extent deregulated and generally subject to free market rules. There are particular concerns, however, that possibilities remain for political influence at local level.

The *print media* is characterized by a wide variety of daily newspapers. There are five daily national papers plus daily papers with local/regional markets. There are three political weeklies. Newspapers, apart from two national daily newspapers, have been privatised, and journalists no longer encounter major obstacles in the exercise of their profession. There is a large degree of political diversity. Nevertheless further measures should be taken to ensure transparency in media ownership. The dominant position in the distribution sector by one group of publishers could result in unfair treatment of competitors (namely some of the biggest publishers control more than 50% of the biggest distribution network in Croatia).

In the *audio-visual field*, there are more than 130 radio stations and foreign broadcasters airing their programmes. The state TV broadcaster (HTT) has lost its monopoly position. The privatization of the third national TV channel to a Croatian RTL consortium could promote the development of the private broadcasting sector and introduce competition and pluralism within the television market. In addition to the three TV channels that cover the whole country, there are several regional TV networks. There are no restrictions regarding access to foreign news sources. Foreign TV channels are available on satellite and on cable TV.

The legal and administrative framework currently in force in Croatia was adopted with the intention of harmonizing Croatian legislation with European standards. However, there are concerns about the remaining possibilities of political influence on regulatory bodies that have been created.

There are four important laws in the field of Media: (i) the *Law on Croatian Radio-Television (HRT)* of March 2003, regulates the functioning of the State broadcaster, HRT, and provides for programme principles and obligations. The procedure for the appointment of the members of the HRT Council does not provide the necessary transparency, nor does it secure the political independence and plurality of views required of broadcasting regulators. The members of the Council were selected⁴, after a long delay, more on the basis of political preference than relevant experience. Civil society representatives should play a larger role in the appointment and nomination of Council members;. (ii) The *Law on Electronic Media*, adopted in July 2003, governs electronic radio and TV broadcasts, as well as electronic publications. It also outlines the procedure for the allocation of licences for public and private radio and TV broadcasters. A Council for Electronic Media (a supervisory regulatory body) will grant and cancel licences for frequency allocations, exercise supervision and hear complaints. The procedure for the appointment of the members of the Council does not provide the necessary transparency, nor does it secure the political independence, and the plurality of views, proper funding and staffing required for broadcasting regulators, The adopted Law is not fully in line with the European Convention on Trans-frontier Television

⁴ On 17 October 2003 Parliament agreed on the selection the members of the Council. Six members have been nominated by the previous ruling coalition and five by the opposition. The Council consists of 11 members from different civil society groups.

and the Television Without Frontiers Directive (*see also Chapter 20–Culture and Audio-visual*). (iii) *Law on Telecommunications*, adopted in July 2003, aims at opening the way for liberalisation in the field of telecommunication services by creating conditions for new operators in the fixed and mobile telecommunication services. The law establishes a Telecommunications Agency as an independent regulator, which deals with frequency allocation and other technical issues. However the relations between the Telecommunication Agency and the Council for Electronic Media are not clearly defined and might lead to deadlocks in the work of the two bodies. The law is largely in line with international standards but its aspects related to broadcasting need urgent reform. (iv) *The Law on Media*, (formerly called “Law on Public Information”) adopted in October 2003, regulates the basic principles for the work of non-electronic (i.e. mainly printed) media, such as the freedom of expression, the right of the public to information, protection of privacy and media ownership. However, in January 2004 the Constitutional Court repealed the Law for procedural reasons (it was not adopted by absolute majority despite the fact that it was dealing with fundamental human rights). According to the Constitutional Court decision, the Media Law can apply provisionally until 30 April 2004. Croatia should ensure that revised Media Law takes full account of Article 10 of the European Convention on Human Rights (ECHR) as well as other relevant Recommendations adopted by the Committee of Ministers of the Council of Europe.

The *Law on Changes to the Criminal Code* adopted in July 2003, which included the criminalization of libel by journalists, was annulled by the Constitutional Court in November 2003 because it was not adopted by an absolute majority. It is now important that, in the revised law, the legislation concerning libel reflects European Standards (as defined in the jurisprudence of the European Court of Human Rights).

In *conclusion*, changes are required to bring the above mentioned laws into line with European standards, in accordance with the recommendations formulated in February 2004 by the joint expert mission of the Council of Europe, the European Commission and OSCE.

The *right of ownership* is recognised by the Constitution. However foreigners are still subject to certain limitations defined by law, notably as regards ownership of agricultural land, forests, protected parts of nature (national parks, natural reserve etc.). Foreign natural and legal persons may become owners of real estate in Croatia under condition of reciprocity and upon approval by the Ministry of Foreign Affairs. Also in the case of inheritance, foreigners must meet the condition of reciprocity.

The process of *restitution of dispossessed property* during the Yugoslav communist regime has been regulated by a Law that entered into force in January 1997. The process is proceeding very slowly; after 7 years of implementation only in 34% of cases (more than 51.000 cases were submitted) has a legally valid decision been made and only 21% of claims have been positively decided. The Law provides for the possibility that only the first line descendants may request compensation under the condition that they satisfy certain eligibility requirements. The Government is unable to predict a timeframe within which the procedure shall be completed.

The *respect of privacy* is guaranteed. The Constitution guarantees inviolability of homes, freedom and privacy of correspondence. Only a court may order the search of a home or other premises by means of a motivated warrant.

According to available information there are no registered *stateless persons* in Croatia as a result of the dissolution of the SFRY.

1.2.2. *Economic, Social and Cultural Rights*

In 1999 Croatia ratified the 1961 European Social Charter and the Additional 1999 Protocol, both of which entered into force in March 2003. In February 2003, Croatia also ratified the 1991 Protocol amending the European Social Charter. Croatia has not yet signed the 1996 European Social Charter.

The Croatian Constitution provides for economic, social and cultural rights. Entrepreneurial and market freedoms are guaranteed and the State is committed to ensuring all entrepreneurs have an equal legal status. Furthermore, the right to work with full access to all jobs and duties for everyone under the same conditions including the right of employees and of members of their families to social security and social insurance are recognised. There is a range of different welfare benefits included in the Constitution. The Constitution provides for the universal right to health care and special care for the weak, helpless and disabled, with emphasis on social integration programmes. However, budgetary constraints limit the scope of those rights. Families enjoy special protection. Motherhood and childhood are protected by the State.

Croatia, as a successor state of Yugoslavia, implements the UN Convention on the *Rights of the Child*. Croatia should present the second initial report on progress on implementation of the Convention in May 2004. In summer 2003, Croatia introduced the institution of the Children's' Ombudsman.

There are no obstacles to establishing *trade unions*. The right to strike is guaranteed with some restrictions for the armed forces, the police, the public administration and the public services (e.g. health personnel).

There is a right to free primary *education* and free access to secondary and higher education with freedom to establish private schools and educational institutions.

Religious freedom is guaranteed. While the church is separated from the State, an agreement between Croatia and the Holy See establishes a favourable framework regarding the work and activity of the Catholic Church within society. Religious teaching is not obligatory but is performed within the state educational system. Croatia has signed similar agreements with the major faiths in Croatia (e.g., Catholic, Orthodox, and Muslim) apart from Judaism. The return of Jewish property is the main obstacle to concluding such an agreement.

Homosexual relations are recognised by the Law. The Law on Equality of Sexes prohibits discrimination on the basis of sexual orientation.

1.2.3. *Minority rights, protection of minorities and refugees*

Minorities

According to the 2001 census, 7.5% of the Croatian population are members of 16 *national minorities*. The most numerous are the Serbs with 4.5% of the total population, followed by Bosniacs (0.47%), Italians (0.44%), Hungarians (0.37%), Albanians (0.34%), and Slovenes (0.3%). According to the latest official statistics, the corresponding proportion of Roma was 0.21% but the actual figure is probably significantly higher.

Croatia has ratified all the Council of Europe conventions which it has signed, such as the European Convention on Human Rights and Fundamental Freedoms, the Framework Convention for the Protection of National Minorities, the European Charter for Regional and

Minority Languages, as well as the UN Convention on Civil and Political Rights. Furthermore, Croatia has concluded bilateral agreements on protection of national minorities with Hungary and Italy. A bilateral agreement with Serbia and Montenegro is in preparation.

The Constitutional Law on the Rights of National Minorities (CLNM), adopted on 13 December 2002, sets the domestic legal framework for minority rights in Croatia. National minorities are guaranteed the right of having up to eight representatives in Parliament. At local level, minorities have the right to have representatives in elected bodies as well as judicial and administrative bodies of municipalities and cities. The CLNM also provides for minority representation in judicial and administrative bodies at state and local level.

In addition, an advisory Council of National Minorities at national level and local advisory bodies to city/municipality councils were established. The government should work closely with the Council of National Minorities in implementing the CLNM.

Furthermore, a special legal framework is in place regarding the rights of the Serb minority in the Danube region; this was established by the Erdut Agreement and the Government Letter of Intent of 1997. While most of the rights guaranteed under the Erdut Agreement are transposed into the CLNM, some specific rights arise from the Letter of Intent, such as proportional representation in the police force and the judiciary and rights to minority schools.

Members of national minorities in Croatia exercise their right to use their mother tongue officially on an equal basis on the territory of cities/municipalities and counties, if their share of population is at least one third or if so provided by international agreements. Also, they have the right to education in their language from pre-school onwards (up to secondary education) in accordance with the Constitution, the Constitutional Law on the Rights of the National Minorities (2002), the Law on the Use of the Language and Script of National Minorities (2000) and the Law on Education in the Language and Script of National Minorities (2000).

An educational institution with tuition in a language and script of a national minority can be a public institution, funded by the State Budget, or a private school established by any legal or natural person under the same conditions that apply to the establishment of any educational institution. The principles of equality and non-discrimination, protection of the national identity, social integration, freedom to establish educational institutions, educational programmes and curriculum and the provision of adequate teacher training appear to be incorporated in the Croatian legislation. These principles are consistent with the basic principles contained in the Council of Europe Framework Convention for Protection of National Minorities and the European Charter for Regional or Minority Languages.

Ombudsman could play an important role for protection of minority rights but faces serious budgetary constraints. There is a Government Office for National Minorities. In the 2003 State budget, HRK 20 million (€ 2.6 million) are allocated for minorities to be distributed through that Office.

Eight representatives of national minorities were elected at the parliamentary elections on 23 November 2003, which is an increase compared to the 2000 elections where 5 representatives were elected by national minorities.

According to the last Census 331,383 Croatian citizens who are members of 16 national minorities have the right to elect 471 Minority Councils with 6662 councillors and 143 representatives on local (municipality) and regional (county) level. Elections for *local*

advisory Councils of Minorities were held on 18 May 2003. However, due to the short preparation period, low support from the Government and the low organisation at the level of minority organisations, only less than half of the Councils to which minorities are entitled under the Constitutional Law on National Minorities have been elected. Additional elections for members of the Councils of National Minorities were held on 15 February 2004 in 15 counties, 64 towns, and 132 municipalities. The turnout was around 8% of the total minority population. There are still misunderstandings and a lack of awareness with regard to the formal establishment of the local Councils, not only among the local authorities but also among the minority groups themselves.

According to the Constitutional Law on National Minorities, by-elections have had to be held in those counties/municipalities where not enough minority representatives could be nominated through party lists. These by-elections were only held on 15 February 2004 whereas, according to the CLNM, they should have been held by 23 March 2003. It should be noted that under the Law on Local Elections of 2001 these elections should have been held already by September 2002.

With regard to minority representation in state administrative and judicial bodies, as envisaged by the CLNM, minorities are still underrepresented. The Government, referring to practical difficulties, the constraints of the State budget and, in the case of the judiciary, to the independence of courts in selecting judges, has not developed a programme to remedy under-representation in the long term. Although a significant number of positions in the State administration and the judiciary have been advertised, it is not known whether members of national minorities are among the new employees. Also, certain legislation has still to be brought in line with the CLNM, such as the Law on State Administration, the Law on Courts, the Law on the State Judicial Council and the Law on the State Prosecutor's Office. Appropriate measures to address and remedy this situation, need consequently, to be taken.

With regard to the media, minorities and issues of their concern have been increasingly, albeit not yet adequately, covered over recent years, both in electronic media and in the press. Although hate speech is constantly decreasing, national minorities are perceived and presented as separate entities and not as an integral part of the society. Provisions of the CLNM that public radio and TV stations at national and local level have to produce and/or broadcast programmes for minorities in their languages have still to be implemented.

With regard to Court proceedings on discrimination against minorities, there are no indication of any verdicts in which discrimination against minorities or criminal guilt for spreading racial hatred has been established.

The Serb minority is in a distinct situation. First, although it is still the minority with the largest number of citizens, its share of population has decreased dramatically from 13% (1991 census) to 4.5% (2001 census) of the population. Secondly, relations between the Croatian State and the Serb minority are burdened by the legacy of the recent war, i.e. return of refugees and restitution of their property [*see paragraph on "refugees" below*]. With the independence of Croatia their status changed from that of a constitutive nation in former Yugoslavia to a national minority. In December 2003 the new Government signed an agreement with the representatives of Serb minorities, and offered them several positions in the administration. It is to be noted, however, that the existing institutions of the Serb minority (political parties, schools, cultural organisations) can work without any obstacles. In the Danube region, most of the provisions of the Erdut Agreement and the Government Letter of Intent have been implemented, with the important exception of proportional representation

of Serbs in the judiciary. The State, still needs to make additional efforts to integrate the Serb community into Croatian society at all levels.

The *Roma minority* deserves special attention. The Roma population officially accounts for 0.21 % of the population (9,463 persons, according to the 2001 census). However, their estimated number is significantly higher (30,000 to 40,000) as Roma often declare themselves as members of the majority group or do not register. Most Roma are not integrated into Croatian society and suffer discrimination in all fields of public life such as access to employment, health and political representation.

In view of the acute social exclusion in which most of the Roma population lives in Croatia, on 16 October 2003, the Government adopted, encouraged by the Council of Europe and OSCE, a National Programme for the Roma. The Programme envisages a series of measures to ensure the social inclusion of the Roma, preserving their tradition and culture. It addresses issues such as status, political representation at local level, employment, children's rights, education, health care, social welfare, housing and environmental protection. It remains to be seen, however, whether the funds allocated to this initiative in the 2004 State Budget are adequate to implement the Programme.

There is a very high number of cases pending in the ECHR against Croatia. This appears to reflect (i) procedural problems in the Croatian judiciary including the extent to which the Constitutional Court is able to act as an effective domestic remedy on human rights issues and (ii) substantive human rights concerns, regarding some legislation, particularly laws governing property issues related to the war.

Refugees

Croatia has ratified the 1951 Geneva Convention on *Refugees*. A number of refugees from BiH have been given refugee status under the Croatian Law on the Status of Displaced Persons and Refugees. The definition of refugees under that Law differs significantly from that of the Geneva Convention. While the Law on the Movement and Stay of Foreigners prescribes procedures for granting asylum, there has been no positive decision granting asylum. On 1 July 2004, the new Asylum Law should enter into force.

In the period 1991-1997, the total number of refugees and Internal Displaced Persons (IDPs) from without and within Croatia, was approximately 950,000.

As a result of the recent war, approximately 550,000 *Croats*⁵ became displaced (IDPs). The number of *Croatian Serb refugees*, resulting mainly from the 1995 operations Flash and Storm, through which Croatia took over control of all occupied areas, was 370,000 (330,000 in Serbia and Montenegro and 40,000 in BiH). In addition, 32,000 Serbs were registered as IDPs at the end of 1997 in the UNTAES region (Eastern Slavonia). In addition to the 950,000 refugees and IDPs there were also the Bosnian Croats who either established themselves eventually in Croatia (approximately 130,000) or transited through Croatia to another country.

By the end of 2003, the number of *Croatian Serb refugees* was approximately 209,000 (189,500 in Serbia and Montenegro and 19,500 in BiH). The number of IDPs of Serb ethnic affiliation was 1,700. By the end of the same period 108,000 Croatian Serb refugees returned to Croatia.

⁵ The terms Croat and Serb indicate ethnic affiliation whereas Croatian indicates citizenship of the Republic of Croatia.

Mainly as a result of the long displacement and obstacles to their return, a large number of the current Serb refugees appear to have opted for local integration in the country in which they reside. The census conducted in the second half of 2000 by the Governments of the then FRY and BiH in cooperation with UNHCR indicated that the maximum potential for return of the remaining refugees was around 30%, i.e. approximately a little more than 83,000 individuals (76,500 from SaM and 6,500 from BiH). A survey carried out for the OSCE Mission to Croatia in the second half of 2003 has yielded a potential for return of 15% of the refugees currently in SaM and BiH, which corresponds into a number of approximately 30,000 individuals.

The main issues refugees face upon return are housing, mines, economic re-integration, potential harassment based on “war crimes” allegations and the inhospitable atmosphere within the receiving local communities. In addition there are administrative problems such as non recognition of pension rights based on working years in the formerly Serb controlled areas. In terms of economic re-integration, the Government has put in place measures for the economic development of the areas of return but with no specific measures intended for returnees. The necessary budgetary resources have been made available and the process of determining is planned to be completed by 2010.

During the war and afterwards, many houses and/or apartments were either destroyed or occupied. Thus, the housing problem can be divided into three parts which are: (i) reconstruction; (ii) repossession of property and (iii) provision of housing care for former tenancy right holders.

Reconstruction: to date, the Government has reconstructed approximately 130,000 out of the 200,000 destroyed houses and apartments. Seven percent (7%) of this programme has been funded by the International Community. There appear to be no major delays in the implementation of the reconstruction programme of the estimated 16,000 remaining houses and it is expected to be completed by the end of 2005. This would facilitate the return of approximately 48,000 individuals. With the amendments of 2000 to the Law on Reconstruction, the last discriminatory legal provisions were removed. The deadline for request for reconstruction was the end of 2001. In March 2004, in accordance with the agreement signed with Serb representatives the Government re-opened the deadline for submission of new requests for reconstruction from 1 April to 30 September 2004. This will probably mean that reconstruction programme will have to continue until 2006.

Repossession of property: The repossession of residential property awarded to temporary users under the Law on Temporary Take Over and Administration of Specified Property is regulated by the 2002 Amendments to the Law on Areas of Special State Concern. The Law on Ownership and Other Proprietary Rights governs the repossession of other types of property, for example, business properties and agricultural land, which could also have been assigned to temporary users through the Law on Temporary Take Over and Administration of Specified Property. Funds have been provided by the Government to provide alternative accommodation. By the end of 2003, out of the total number of approximately 20,000 applications for houses to be repossessed⁶, just under 16,000 have been repossessed (out of which 4,000 remained empty since there is no knowledge of owners’ whereabouts). However, the pace of property repossession is very slow. The main reasons are (i) the self imposed task to provide alternative accommodation to occupants as pre-condition for repossession (which

⁶ This concerns repossession of houses that were awarded for occupation under the Law on Temporary Take Over and Administration of Specified Property of 1995.

means that the owners' rights are not fully acknowledged); (ii) the lack of urgency at lower level in the state administration, to provide alternative accommodation to the occupants in time⁷; and (iii) the failure of courts to order evictions and the non-enforcement of decisions for the eviction of illegal occupants. Originally, the Government planned to finalise property restitution by the end of 2002. This deadline was then postponed to the end of 2003. However, the new deadline has not been met. By end of 2003, 3,500 houses were still occupied for which around 2,200 requests for repossession have been made. The Government's agreement with the Serb representatives stipulates that this process should be completed by the end of 2004.

Housing for former tenancy right holders: Until recently, refugees who lived in socially owned houses with occupancy/tenancy rights had no access to housing if they decided to return to Croatia. This lack of remedy discriminately affected the refugees from urban areas. In July 2002, the amendments to the Law on the Areas of Special State Concern⁸ opened a possibility for remedies for former holders of tenancy rights, for the first time, in these areas. On 12 June 2003, the Government also adopted a Decision to also provide housing care for those former tenancy right holders outside the Areas of Special State Concern who wish to return⁹. This Decision foresees that publicly financed housing would be made available to the applicants. The deadline to submit a request is the end of 2004. The deadline for providing housing care is 31 December 2006. The programme does not address the issue whether the termination of occupancy/tenancy rights were legally justified and there are a large number of domestic court proceedings ongoing and at least one case has been declared admissible to the ECHR ("Blecic v. Croatia").

As the Implementation Plan of the Government decision was signed after considerable delay only on 29 October, there are no concrete results yet. To date no decision in favour to former tenancy right holders has been taken. The Government expects to meet all requests by the end of 2006. In the 2004 State budget, approved on 4th March 2004, budget is allocated for the construction of approximately 1,500/1,600 apartments to cover the first requests. It is hard to assess the impact of these measures on return.

In **conclusion** the Croatian Government has put in place provisions to provide housing solutions to refugees and IDPs who wish to return. However, the implementation of these provisions, with the exception of the reconstruction programme, has to be accelerated and improved. The return of some other types of property than housing has still not been addressed in the same legal way as the repossession of housing. Also, additional efforts should be made as regards the sustainability of returns. This concerns the improvement of the economic situation and the general atmosphere in the areas of return.

1.3. Other obligations defined by EU Council conclusions of 29 April 1997

The government has committed itself to comply with its obligations under the *Dayton/Paris*

⁷ Restitution of property to the owner is envisaged only after alternative housing is provided for the temporary occupant. This means that the interest of temporary occupants are given precedence over the legal rights of owners.

⁸ See Map attached. The Areas of Special State Concern, defined by a Law of 1996 (subsequently amended) were designated for the purpose of eliminating the consequences of the war, ensuring the faster return of IDPs and refugees, encouraging demographic and economic revival and achieving a balanced development of all regions in Croatia.

⁹ The amendments to the Law on the Areas of Special State Concern, adopted in July 2000 and July 2002, deal with this issue for cases inside these areas.

Agreements. It respects the sovereignty and territorial integrity of Bosnia and Herzegovina. Under the ***Erdut Agreement***, signed in November 1995, Croatia accepted a number of obligations in order to achieve the peaceful re-integration of the area of Croatian Danube Region (Eastern Slavonia, Baranja and Western Sirmium) under the sovereign control of the Croatian Government as of January 1998 (when UNTAES, the UN Transitional Authority, withdrew from the territory). This Agreement, and its Letter of Intent of January 1997 to the UNSC, continues to be legally binding obligations. Some provisions have been incorporated in the Constitutional law on National Minorities, not yet fully implemented. In particular Croatia maintains its commitment to implementing all obligations related to the return of refugees and internally displaced persons (IDPs).

1.3.1. Cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY)

Croatia's cooperation with the ***International Criminal Tribunal for the former Yugoslavia (ICTY)*** has improved significantly in the past few months. In April 1996 Croatia adopted the Constitutional Law on the Co-operation with ICTY and established the "Office of the Government for co-operation with the International Court of Justice and International Criminal Courts". So far ICTY indicted a total of 5 Croatian citizens from the Republic of Croatia for criminal offences committed in the Republic of Croatia and 27 Croats from Bosnia and Herzegovina for criminal offences committed in the territory of that state.

None of the three Croatian citizens indicted in 2001 and 2002, has been transferred by the Government to ICTY for different reasons. Mr. Rahim Ademi (indicted on 8 June 2001) voluntarily surrendered to the Tribunal in July 2001; Gen. Janko Bobetko (indicted on 17 September 2002) died in April 2003, after the Government challenged ICTY on some parts of the indictment which, in the Government's opinion put into question the political justification and legitimacy of a particular action of the Croatian Army; and General Ante Gotovina indicted on 8 June 2001 related to alleged war crimes that occurred during and after "Operation Storm" in 1995, based on individual and command responsibility) is still at large. On 1st March 2004 Croatia received sealed indictments against former Army Generals Cermak and Markac who voluntarily surrendered to the ICTY on 11 March 2004.

Of the 27 Croat indictees from Bosnia and Herzegovina, four were arrested in Croatia and transferred to ICTY. Eighteen voluntarily surrendered to ICTY. Among these, in early April 2004, the ICTY unsealed an indictment dated 4 March against six Croats who served as political and military officials in the so-called "Herceg-Bosna", a war-time entity established by ethnic Croats in Bosnia and Herzegovina. All six suspects, who have Croatian citizenship and permanently resided in Croatia, voluntarily surrendered to the ICTY on 5 April, appeared before the Tribunal on 6 April and entered pleas of not guilty to all 26 counts in the indictment. The others Croat indictees from Bosnia and Herzegovina have been arrested by SFOR or authorities in other countries.

Croatia has recently taken steps to provide access to internal documentation, and allows interviews with potential witnesses to the satisfaction of ICTY. In October 2003 Croatia adopted the Law on Witness Protection to ensure permanent protection to witness in criminal proceedings¹⁰.

¹⁰ The Law prescribes four types of protection: corporal and technical protection, transfer of the person, measures for hiding the identity and ownership, change of identity.

In August 2003 the UN Security Council called upon Croatia to intensify its co-operation with ICTY and in particular to surrender indicted fugitive General Ante Gotovina to the Tribunal. Croatia delayed execution of the arrest order in the case of General Bobetko before his death.

Croatia accepts the notion of command responsibility as defined by the ICTY Statute (Art. 7.3) and the Rome Statute of the ICC (Art. 28). The current Criminal Code does not explicitly penalize command responsibility. The Law on amendments to the Criminal Code (of July 2003), which introduced into the national legislation the basic type of command responsibility from the Rome Statute, was abolished by the Constitutional Court in November 2003, because the Law was not adopted with the necessary majority of votes. However, the Supreme Court has suggested in at least one decision that commanders can be held responsible under the currently applicable Criminal Code for the failure to prevent war crimes about which they knew or should have known.

In **conclusion** co-operation with ICTY has improved significantly in the past months. In April 2004 the Prosecutor stated that Croatia is now co-operating fully with ICTY. However Croatia needs to take all necessary steps to ensure that the remaining indictee is located and transferred to ICTY.

The authorities appear determined to improve conditions for **prosecution of war criminals in domestic courts**. In the period from 1991 to 2003, criminal proceedings for about 3,100 persons were instituted out of which more than 1,300 persons were indicted and 548 persons were sentenced by final verdict (the majority "*in absentia*").

A special office for war crimes does not exist. Special Investigative departments in the 4 County Courts in Split, Zagreb, Rijeka and Osijek for the prosecution of war crimes have been established by the Law on the Implementation of the Rome Statute of the International Crime Court (ICC), adopted on 17 October 2003. However, these Departments do not function – and the responsibility for their establishment falls on the Presidents of the County Courts who have not yet taken any action. It is still unclear how the jurisdiction (territorial, material) will be defined and by whom, how judges would be trained and if there is the possibility for the four departments to cooperate amongst themselves should they have to exchange documents/evidence.

Statistical data suggest that a single standard of criminal responsibility is not yet applied equally to all those who face war crime charges before Croatian courts. Defendants of Serb ethnicity are disadvantaged at various stages of judicial proceedings compared to Croats. Thus, Serbs were more likely to be convicted than Croats in 2003, although the differential decreased from 2002. While the number of Serbs prosecuted in 2003 increased as compared to that in 2002, the number of Croats decreased substantially. The Supreme Court reversed a considerable number of convictions of Serbs on appeal, ordering new trials on the basis of errors by the trial court. In addition, local prosecutors and courts continued to conduct *in absentia* proceedings (27 out of 32 Serbs convicted of war crimes in 2003 were convicted *in absentia*). Such proceedings are used almost exclusively against Serbs, and many of these are collective indictments. This practice is problematic because it is not consistent with the principle of individual guilt. Continuation of this practice also creates an additional burden on the courts as defendants convicted *in absentia* regularly make use of their right for re-trial. Some improvements have been achieved in recent years, but further reform is necessary in order to reach the even-handed administration of criminal justice in war crime cases.

Significant delays continue in judicial proceedings, both at trial courts and at the Supreme Court. Moreover, a number of cases have shown severe shortcomings in the administration of

justice, e.g. the “Lora Prison” case in Split as well as several cases in the district courts in Gospic and Zadar. The Gospic Country Court found a Serb returnee guilty not only of war crimes, but also of a 500-year history of Serb crimes against Croatia (“Karan case”, later reversed by the Supreme Court). On the other hand, the State Prosecutor has started a number of investigations against Croats suspected of war crimes against Serb civilians over the past year; the experience has so far been mixed. The Gospic trial in Rijeka (“Norac case”) is a good example of a properly processed criminal trial.

In principle, Croatia is prepared to co-operate closely with ICTY on domestic war crimes trials, including by accepting as legally relevant all the evidence and other supporting material from ICTY. Evidence obtained by ICTY will be admissible without review in domestic trials.

Croatia supported the EU Common positions on the **International Crime Court (ICC)** and as a result decided not to sign a bilateral agreement on non-extradition to the International Criminal Court with the United States.

1.3.2. Regional Co-operation

Croatia is an active member of several regional and sub-regional initiatives, such as the Stability Pact, the Adriatic–Ionian initiative, the “Quadrilaterale” (between Italy, Slovenia, Hungary and Croatia), the Central European Initiative (CEI), South-East Cooperation Initiative (SECI), the Alps-Adriatic initiative, the Danube Commission. Croatia is an observer in the South-East European Cooperation Process (SEECP). Croatia’s membership of such initiatives may be considered proactive, despite clear reluctance by Croatia to be considered a country of the Western Balkan region.

In December 2002, Croatia signed the Sava River Basin Framework Agreement with Slovenia, BiH and Serbia and Montenegro. In February 2003 Croatia signed the Memorandum of Understanding on Regional Electricity Market in South East Europe (REM) and in December 2003 its addendum (*see also chapter 14 – Energy*)

First negotiations on the distribution of SFRY assets started in 1992 and *the succession Agreement* was signed on 29 June 2001 by the five successor states (Slovenia, Croatia, BiH, Serbia and Montenegro and the Former Yugoslav Republic of Macedonia). The Agreement has been ratified by all successor states. Croatia has been the last one and Parliament ratified in March 2004. The purpose of the Agreement is to identify and determine equitable distribution of rights, obligations, assets and liabilities of the former SFRY amongst its successor states. It sets out only the basic principles and procedures for interpretation and implementation of the Agreement.

In 1996 Croatia established diplomatic relations with **Serbia and Montenegro (SaM)** but relations remain difficult. After 2000, with change of regimes in both countries, economic co-operation started to develop. Bilateral trade is still very low but is increasing. At their first official meeting in November 2001 in New York, the two Foreign Ministers agreed on priorities for the further normalisation of relations. Since then, relations between the two countries have improved considerably and regular contacts on working level have been established. Croatian President Mesic’s visit to Belgrade in September 2003, and particularly the apologies expressed by the two Presidents for pain and suffering that the two peoples caused each other in the past, are further important steps towards normalisation of relations.

However there are still important open questions to be resolved: the border demarcation at the Danube river and at Prevlaka, succession related issues, the problem of missing persons,

Croatia's claim for compensation for war damage, return of refugees and restitution of their property, in particular property restitution to business entities and the ratification of the FTA by SaM. After long negotiations, a *Free Trade Agreement* was signed on 23 December 2002 in Zagreb. The Croatian Parliament ratified the Agreement on 7 May 2003. But SaM has still not ratified this Agreement.

An Inter-State Border Commission for Identification and Demarcation of the Land and Delimitation on the Sea was established in December 2001 to deal with border demarcation at the Danube river (347 kilometres). In view of the political and technical complexity of the negotiations (clarification of ownership, possible compensation of owners, etc.), the Inter-State Border Commission has made only modest progress so far¹¹. It is now working on the establishment of a small border regime in order to grant owners access to their property on the disputed territory until a permanent solution is found.

In December 2002, Foreign Ministers signed a Protocol on a Temporary Regime for Prevlaka. After the mandate of the UN Mission of Observers (UNMOP) ended on 15 December¹² Croatia took over full jurisdiction over Prevlaka. The Temporary Regime provides for the establishment of a demilitarised zone into the sea along the Bay of Kotor between the capes of Konfin and Ostro. The zone is controlled by joint Croatia-SaM police patrol boats. The Protocol provides for the possibility of establishing additional crossing points. It also foresees the establishment of a small border regime for local population. Without prejudice to the final border demarcation, a temporary border line at sea has been agreed upon. This line is not in the middle of the Bay of Kotor but leaves the greater part to SaM. Such an asymmetric solution was agreed to in earlier negotiations in 1998 and submitted to the UN Security Council at that time. Implementation of the Regime seems to be satisfactory. The small border regime is in place and no incidents in the demilitarised zone are reported. However, there are at the moment no negotiations on the final demarcation of the sea border.

The issue of *minorities* is one of the most sensitive political questions in normalisation of relations. Both countries have adopted Constitutional Laws on Minorities. The Laws regulate rights and issues of concern for all minorities in the respective country. However, a bilateral agreement on minorities is yet to be signed.

In May 2003 Serbia and Montenegro abolished *visas* for citizens from the EU and neighbouring countries, including Croatia. In June 2003 Croatia abolished temporarily the visa regime for SaM citizens for the period of 10 June to 31 December 2003. This was subsequently extended to the period of 31 January and then 30 June 2004. The Croatian Government outlined three political conditions for the permanent abolition of the visa regime: (i) return of registers of births, marriages and deaths of Croatian citizens which were taken to

¹¹ At its last meeting on 25 July 2003 the two sides agreed on the demarcation of two "zero points", one at Bajakovo and one at the Croatian/BiH/Serbian triangle, Racinovci, near Brcko. Currently, the relevant SCG authorities examine the Croatian claims that are based on the land cadastre.

¹² In 1992 Croatian President Tudjman and Yugoslav President Cosic reached an agreement to withdraw Yugoslav army (JNA) from Prevlaka peninsula and the Bay of Kotor, and a UN Mission of Observers (UNMOP) was established on 1 February 1996 to demilitarise this area. On 11 October 2002, the UN Security Council decided on a last extension of UNMOP until 15 December 2002, considering Prevlaka no longer a security issue.

Belgrade in 1995;¹³ (ii) replacement of SaM military at the Danube border by police; (iii) full cooperation regarding the search for missing persons.¹⁴

In July 1999 Croatia filed a lawsuit against the then FRY with the International Court of Justice charging FRY for genocide and demanding, amongst others, *unspecified compensation for war damages*.¹⁵

At the beginning of the war, Croatia passed several decrees regulating the issue of *property* owned by the former SFRY and its Republics. In general, this legislation prohibited the former Federal State and its Republics, the Yugoslav Army as well as legal entities established outside Croatia to make use of their immovable property on the territory of Croatia. As a consequence, this property was included in the privatisation process under the Law on Transformation of Socially Owned Firms and the Law on Privatisation. Many Croatian legal entities that had branch offices in other former Yugoslav Republics have been deprived of the free use of their property, particularly in Serbia and Montenegro. Since the SFRY succession agreement has not yet been ratified, legal entities are forced to undertake individual legal actions through the judicial/administrative system or to enter into direct negotiations with current possessors of their property. So far, only a few of them have regained ownership of their property.

Relations with **Bosnia and Herzegovina** (BiH) improved after a new Croatian Government came to power in January 2000. Since then, the countries have developed good diplomatic relations. Aiming at the strengthening of BiH central state institutions, Croatia has renounced to previous policy of "special parallel relationship" with the Federation of BiH (i.e. the BiH entity of Muslims and Croats). Instead, it has established political co-operation exclusively with the central State authorities in Sarajevo. An agreement on return was signed in December 2001 in order to facilitate and accelerate the return of refugees. Two other important agreements were signed in June 2002, on fighting terrorism and organised crime and on joint border crossings.

Trade with Bosnia and Herzegovina had been completely liberalised according to the Economic Cooperation Agreement signed on 24 March 1995, and the Protocol on Rules of Origin signed on 26 February 1996, and a FTA is in force since 1 January 2001.

Notwithstanding these positive developments, there has been only a slight progress in bilateral relations, to a large extent due to BiH internal factors. Pending issues are the agreement on the port of Ploce, dual citizenship and restitution of property.

Agreement on the *Port of Ploce* is still outstanding. The Agreement, signed in 1998, allows BiH free transit across Croatian territory to the Port of Ploce and also free transit for Croatia through BiH territory at Neum, approx. 60 km north of Dubrovnik. The main problem in this Agreement is its Article 9 stipulating that a committee of seven members would administer the Port of Ploce: Croatia and BiH would each appoint three representatives and the

¹³ On 14 August 2003, the Serbian Government decided to return 420 registers.

¹⁴ Cooperation has improved considerably over the last two years. Nevertheless, Croatia is still looking for 1 275 missing persons, whereas SaM is officially looking for 520.

¹⁵ Croatia requested the Court to adjudge and declare that FRY has breached its legal obligations to Croatia under the 1948 UN Convention on the Prevention and Punishment of the Crime of Genocide and that FRY has to i) make possible the processing of persons suspected of committing the crime of genocide, ii) provide data on missing persons, iii) return the alienated cultural property and iv) pay compensation for damages caused by the mentioned violation of international law.

International Court on Maritime Law one; the latter would have the right to make final decisions, in case of disagreement between the two countries. In Croatia's view this represents a kind of "international protectorate" over its national territory¹⁶. BiH, having already ratified the Agreement, has basically accepted it, but wants the Agreement to be ratified by the Croatian Parliament as it is and modify it later through an amendment. Croatia, however, refuses ratification before amendments to Article 9 are made. After long and arduous negotiations, the Croatian Government and the BiH Council of Ministers adopted a special Protocol in July 2003, defining the future procedure. However, the signature of the Protocol scheduled for August 2003, did not materialise. The BiH Presidency, in charge of foreign policy, had – unexpectedly - not adopted the Protocol as the Bosniac member of the Presidency has put forward new requests.

The Croatian Government and the BiH Council of Ministers have been negotiating a bilateral agreement on dual citizenship. The basic provisions are that citizens with dual citizenship will have to complete military service only in one country and pay taxes and vote only in the country of residence. This would have a significant political impact because Bosnian Croats with residence in BiH would no longer be eligible to the vote in Croatia. Despite progress made, the Agreement is not yet ready to be signed. Neither Croatia nor BiH have yet signed a bilateral *agreement regulating the restitution of property* of private persons and legal entities situated in the territory in one of the two countries.

Relations with the **former Yugoslav Republic of Macedonia** are generally good and there are no open issues. The countries have signed 24 bilateral agreements. Negotiations for a bilateral convention on regional co-operation under Article 12 of the SAA started immediately after the signature by Croatia of the Agreement, but no progress was achieved during the last year. A FTA between the two countries has existed since 1997. A Readmission Agreement has been in force since 2001.

Relations with **Slovenia** have been good since the two countries become independent because Croatia and Slovenia considered themselves as strategic partners in the process of secession from former Yugoslavia. In 1997, a Free Trade Agreement (FTA) between Slovenia and Croatia was signed, which took effect on 1 October 2001. It had already been provisionally applied since January 1998. In May 2002 Slovenia and Croatia signed an additional protocol to the FTA on trade in agricultural products. This FTA will cease to apply on 1 May when Slovenia joins the EU.

However, these good relations have suffered strains as a result of differences over a number of issues. For instance over border demarcation, the joint Krsko Nuclear Power Plant, Ljubljanska Banka, and, recently, over Croatia's declaration of a Fishing and Ecological Protection Zone in the Adriatic.

The border dispute over the *Piran Bay* particularly strained Croatian-Slovene relations in summer 2002 and an agreement over the demarcation of the maritime border, a pending issue since both countries gained independence, has not been reached yet. The border agreement negotiated between Croatian and Slovene Prime Ministers in July 2001, ceding to Slovenia 80% of the bay and a corridor to the open sea, was initialled but not signed, as Croatia

¹⁶ The Agreement was concluded in 1998 under different political circumstances. It was made along with another one, the Agreement on Special Relations with FBiH, the Bosniac-Croatian entity of BiH. As the new Croatian Government in 2000 decided to abandon any plan of confederation with this entity (which was an option under the Dayton Agreement), Croatia found itself in a position where it would not have full sovereignty over its own territory.

regarded it as one component only of a global agreement (including Krsko Nuclear Power Plant and Ljubljanska banka issues) never concluded. Negotiations on the border agreement have come to a standstill. On 10 September 2002 the Croatian and Slovene Prime Ministers reached an agreement on a temporary regime regarding fishing in the Bay of Piran. This Interim Agreement entered into force on 23 September 2002 and has been regularly extended since.¹⁷ However, this Agreement will in no way prejudice the future border between the two countries. So far it has been implemented without major problems.

As consequence of this outstanding border issue, Croatia's unilateral decision of October 2003 to *expand its jurisdiction in the Adriatic* through an ecological and fishing zone has provoked considerable tensions with neighbouring countries.. In October 2003 the Council "called on Croatia to urgently pursue a constructive dialogue with its neighbours meant to meet the concerns of all the parties involved" on this matter. During the first months of 2004 some trilateral meetings have been held (among Italy, Croatia and Slovenia), in order to find a common solution before the entry into force of the "Zone" (2nd October 2004), but no political agreement has been achieved yet.

After ten years of difficult negotiations, an agreement on *Krsko Nuclear Power* plant was eventually signed in December 2001, and entered into force on 1 July 2002. According to it, the plant would be owned, run and used on an equal basis. Also, it regulates all outstanding financial matters between Croatian Electricity Company (HEP) and the Slovene Electric Company ELES arising from issues from 1998 until 30 June 2002. According to HEP, implementation of the Agreement goes smoothly. However, the issue of the nuclear waste disposal is still not regulated. In addition, Croatia has requested from the Slovenian side compensation of US\$ 56 million to HEP for undelivered electricity after 1 July 2002, i.e. the date when the Agreement should have entered into force and to date the two countries have failed to agree on the amount of compensation to HEP.

During the former SFRY, branch offices of *Ljubljanska Banka* in Croatia collected foreign exchange deposits of a total amount of around € 422 million.¹⁸With the dissolution of Yugoslavia, the Ljubljanska Banka branch offices withheld these savings deposits of Croatian citizens. To compensate Croatian citizens, the Government offered depositors in 1991 to transfer their deposits from Ljubljanska Banka to Croatian commercial banks.¹⁹Deposits worth around € 279 million were transferred to Croatian commercial banks as part of the public debt. The remaining part of around € 150 million of deposits was not transferred²⁰ and still represents a claim of individuals towards Ljubljanska Banka. Other former SFRY Republics also have similar problems with that Bank. Agreement is not yet reached on a solution to this problem which affects the region.

Croatia and **Albania** have good political relations and high level political dialogue is ongoing. The FTA between both countries entered into force in Spring 2003, although some difficulties

¹⁷ If adopted as final, it would legally constitute part of the Limited Border Traffic and Co-operation Agreement (SOPS) of 1997 and would, thus, have to be ratified by Parliament.

¹⁸ Stock as of 31 December 1991.

¹⁹ The citizen's foreign exchange deposits with Ljubljanska Banka were transformed into public debt of the Republic of Croatia. Government issued bonds to commercial banks repayable in 20 semi-annual instalments with interest rate of 5%. Apart from receiving the instalments, the citizens had the option to request the bonds from the banks in order to buy state owned flats or stocks and shares of state owned enterprises.

²⁰ At that time a number of depositors hoped to gain better terms (than those offered by the Croatian Government) through direct negotiations with Ljubljanska banka, i.e. the terms that were offered to Slovenian citizens.

in implementation have been experienced at customs points due to poor knowledge of the agreement's detailed provisions. 23 bilateral agreements have been signed including in the areas of health, customs cooperation and readmission. The visa policy between both countries has been facilitated (for business contacts) and in June 2003 Albania abolished visa for Croatian citizens. A FTA applies since June 2003.

Bilateral relations with **Italy** are intensive and of particular importance for Croatia since Italy is its largest trade partner and an important investor. However the basically good relations with Italy are hampered by some important issues. In the first place there is *the "Esuli" question*. Between 1943 and 1947 it is estimated that 90% of the Italian population left Yugoslavia, leaving behind property, which was then nationalised by the Yugoslav state. Compensation for Esuli property is partially regulated by the Osimo Agreement of 1975 and the Rome Agreement of 1981, concluded between SFRY and Italy.²¹ The restitution of nationalised Esuli property is made possible after the Croatian Parliament adopted a new Law on Denationalisation in July 2002 granting the right to restitution and compensation also to foreign citizens if it is stipulated by bilateral agreements. Croatia and Italy agreed to start bilateral negotiations in October 2002.

The unilateral declaration adopted by the Croatian Parliament in October 2003 to extend an exclusive "*Ecological and Fishing Protection Zone*" in the Adriatic was an initiative not in line with the European principle of regional co-operation and, as such, has created some tension in bilateral relations. The lack of co-operation from Croatia *preventing incidents in the Adriatic Sea* is also an open issue. A further issue of special significance in bilateral relations is the protection of rights of the Italian minority in Croatia. Certain progress has been recorded, but constant monitoring is still required.

1.4. General Evaluation

Croatia has stable democratic institutions which function properly respecting the limits of their competences and co-operating with each other. The 2000 and 2003 elections were free and fair. The opposition plays a normal part in the operation of the institutions.

There are no major problems over assuring the rule of law and respect for fundamental rights. However, Croatia needs to take measures to ensure that the rights of minorities, in particular of the Serb minority, are fully respected. Croatia should speed up the implementation of the constitutional Law on National Minorities and accelerate efforts to facilitate the return of Serb refugees from Serbia and Bosnia and Herzegovina. Croatia needs to make substantial improvements in the functioning of the judicial system. The effectiveness of the fight against corruption needs further strengthening.

Croatia's cooperation with the International Criminal Tribunal for the Former Yugoslavia has improved significantly in the past months. In April 2004, the Prosecutor stated that Croatia is now cooperating fully with ICTY. Croatia needs to maintain full cooperation and take all necessary steps to ensure that the remaining indictee is located and transferred to ICTY in The Hague. Croatia remains committed to regional co-operation; sustained efforts are needed in this area. In particular to resolve border issues with neighbouring countries in line with international standards for dispute settlement, and issues arising from the unilateral declaration of the protected "*Ecological and Fishing Zone*" in the Adriatic.

²¹ These Agreements regulate mutual claims for compensation of war damage by former Yugoslavia and Italy. Under the Osimo agreement Yugoslavia was not directly obliged to pay compensation to Italian citizens but to the Italian State, which, in turn, would compensate its citizens, i.e. the Esuli.

2. ECONOMIC CRITERIA

In 1993, the European Council in Copenhagen defined the following economic criteria for accession to the EU:

- the existence of a functioning market economy;
- the capacity to cope with competitive pressure and market forces within the Union.

These criteria are linked. Firstly, a functioning market economy will be better able to cope with competitive pressure. Secondly, in the context of membership of the Union, the functioning market is the internal market. Without integration into the internal market, EU membership would lose its economic meaning, both for Croatia and for its partners.

A candidate country must commit itself permanently to the economic obligations of membership. This irreversible commitment is needed to provide the certainty that every part of the enlarged EU market will continue to operate by common rules. The capacity to take on the *acquis* has several dimensions. On the one hand, Croatia needs to be capable of taking on the economic obligations of membership, in such a way that the single market functions smoothly and fairly. On the other hand, Croatia's capacity to cope with the competitive pressures of the internal market requires that the underlying economic environment be favourable, and that the Croatian economy has flexibility and a sufficient level of human and physical capital, especially infrastructure. In their absence, competitive pressures are likely to be considered too intense by some groups of society, and there might be a call for protective measures, which, if implemented, would undermine the single market.

If Croatia can reach a broad based consensus on the nature of the changes to economic policy required by EU membership as well as a sustained record of implementation of economic reforms, it will be easier for the country to maintain its commitment to the economic obligations of membership.

2.1. Economic developments

Croatia is a small economy with a population of 4.4 million and a gross domestic product (GDP) at current prices of HRK 176.4 billion or €23.8 billion in 2002. The country's population corresponds to about 1.2% of that of the European Union, while its economy is only about 0.26% in GDP terms. The GDP per capita is in the order of HRK 40,000 or €5,400 (measured by the average exchange rate 2002). The GDP per capita in power purchasing parity (PPP) terms for 1999 was USD 8,267 or 35.9% of the EU average²². No reliable regional GDP data are available. First calculations suggest a pronounced variation among the existing 21 counties with the City of Zagreb being far above the average both in absolute terms and per head.

Macroeconomic Background

As a constituent Republic of the Socialist Federal Republic of Yugoslavia (SFRY), Croatia adopted a socialist system with self-management and social ownership. This allowed free pricing mechanisms for most consumer goods and some degree of competition. As a

²² The Croatian Bureau of Statistics calculates the GDP in PPP terms in co-operation with the OECD every three years (last for 1999). GDP per capita data in PPP terms are neither available from the Croatian authorities nor from the IMF on a continuous basis. The Vienna Institute for International Economic Studies (WIIW) estimates the per capita GDP in PPP to have been €9,210 in 2002.

consequence the private sector became relatively developed and the share of services in GDP high compared with other Central and Eastern European countries. The rapid growth experienced during 1950-1980 relied on high investment ratios of 30% or more, supported by heavy external borrowing. Already before independence, a high share of Croatian exports was directed to Western markets even though exports to the countries of the Council of Mutual Economic Assistance accounted for about 25% of total exports (in 1990). Despite persistent trade deficits, the pre-independence balance of payments recorded current account surpluses equivalent to 7-8% of GDP, due to continuous surpluses in the service account coming mainly from tourism. During the 1980s the international debt crisis and reduced capital inflows caused investment to fall and growth to stall. Between 1987 and 1990 GDP fell by about 11%. Ensuing losses in the enterprise sector were accommodated by the banking system and eventually monetised by the authorities, resulting in increasing inflation and eventually hyperinflation.

Immediately after declaring independence in 1991 from the former SFRY, Croatia had to cope with war, which effectively ended only in 1995. War inflicted direct damage, particularly on infrastructure and housing. It also caused indirect economic damage by interrupting the trade flows with the former members of the SFRY as well as the main traffic links between parts of the country. As a consequence, tourism, Croatia's main export industry, was seriously affected (revenues dropped to 10% of pre-war levels).

In parallel, Croatia faced the problems resulting from the change in economic system and the loss of some traditional markets in Eastern Europe. This combination of war impact, independence and economic transition led to serious imbalances: recession, external and fiscal imbalances, high inflation, and increasing unemployment only softened by a conflict-induced reduction in labour force. A thriving stabilisation effort started in late 1993, delivering price stability and an average annual GDP growth of over 6% during 1994-1997. Transition to a market economy was initiated early after independence and the World Bank and the IMF considered Croatia in the mid-90s as one of the most successful countries in transition.

However, the economic situation started to deteriorate again in the course of 1997. In an attempt to calm down signs of overheating, to restrict credit expansion and to stabilise the exchange rate, monetary policy was tightened between late 1997 and 1999. Diversion of liquidity to purchase foreign exchange for speculative purposes and insufficient restructuring that harmed enterprise competitiveness led to a rapid build-up in payment arrears in the economy, both between enterprises and between the state and enterprises. A combination of tight monetary policy, a drop in domestic demand and deteriorating loan portfolios of banks evolved into a banking crisis in 1998/99. The combination of mounting structural problems, increases in taxes and administered prices as well as the impact of the Kosovo crisis contributed to the recession starting in the last quarter of 1998 and continuing until the third quarter of 1999, after which the first signs of recovery were noted. Real GDP contracted by 0.9% in 1999 but grew at an increasing pace in the following years: the average growth rate during 2000-2002 was 4%.

The process of transition from a planned to a market economy in Croatia had major implications for the labour market. The dominant characteristics of the early phase of the transition process in this area were an accelerated shift in the sectoral employment structure, decreasing levels of employment, and increasing unemployment. The unemployment rate (ILO standard) rose from 10% in 1996 to up to 17.0% in the first half of 2001 and then declined again to 14.4% in the second half of 2002. Unemployment rates vary significantly between counties, ranging from 13% to 40%, with particularly high rates in border regions. Long-term unemployment accounted for some 53% of total unemployment in 2002. Youth

unemployment rates (age 15-24) were particularly high, standing at 34.4%. The absolute and relative importance of different sectors and industries has gradually shifted towards that of developed market economies. However, overall job creation in the productive areas of the economy failed to attain sufficient levels to absorb the labour released from uncompetitive firms that were forced to adapt to the new market circumstances. The external accounts position was fragile and showed initially great volatility. Even though tourism receipts and thus the service balance recovered after the war and again after the Kosovo crisis of 1999, the current account has been negative since 1995.

Foreign Direct Investment (FDI) in Croatia remained low until 1995 due to the consequences of the war and the preference given to manager and employee buy-outs in the privatisation process. Subsequently, FDI picked up substantially, in particular from 1998 onwards. According to the national authorities, cumulative FDI inflows from 1993-2002 totalled some €7.45 billion or €1,656 per capita. Roughly 75% of the investments originated in the EU and 15% in the US. Almost two thirds of the investments were related to privatisation projects, mainly in the banking, telecommunications and pharmaceutical sector.

In the immediate post-independence period, the fiscal deficit of the consolidated central government climbed to 5.1% of GDP in 1991. The fiscal situation subsequently stabilised with significantly lower deficits and even surpluses in some years until 1999, when it deteriorated rapidly as a result of the economic crisis. However, the budget presentation clearly underestimated the true impact of fiscal policies, due to the fact that it was drawn up on a purely cash basis that did not reflect the creation of extra-budgetary funds, wide use of arrears and other methods of non-cash payment by the government. Recent estimates on the accruals-based past general government stance, which incorporate these extra-budgetary funds as well as agencies and local governments, show an upsurge of the deficit to a peak of 8.2% of GDP in 1999 and a subsequent gradual decline.

The Croatian National Bank (Hrvatska narodna banka - HNB) was established in December 1990. The Law on the Croatian National Bank stipulates the operational independence of the institution from the government. The HNB formulates and administers the exchange rate and monetary policy. In the absence of effective money markets and interest-sensitive monetary instruments, the main monetary instrument has been to stabilise the kuna against the anchor currency (Deutsche mark and subsequently the euro). It de-facto targets more the kuna-euro exchange rate than money supply. Even though open market operations theoretically exist, the HNB usually controls money supply through the use of indirect instruments, such as reserve requirements, and refinancing credits. The HNB has been successful in achieving price stability at single digits since 1995.

The Croatian dinar was introduced on 23 December 1991 as a transitional, interim currency of the independent Croatian State and became the sole legal tender in Croatia on 1 January 1992. In May 1994, the Croatian kuna (HRK) replaced the Croatian dinar. As a legacy of the past hyperinflation, the Croatian economy is currently still characterised by a large degree of currency substitution or de-facto euroisation. The current Croatian exchange arrangement is classified as managed floating with no pre-announced path for the exchange rate of the Croatian kuna. In May 1995 when Croatia accepted the obligations of Article VIII of the IMF Statute, the kuna became fully convertible for current account purposes.

Merchandise trade with the EU has always been relatively significant and developed further until 1995, when the EU share of Croatian trade reached some 60% for both exports and imports. During the Kosovo conflict the EU share of Croatian exports fell to below 50% but recovered to approximately 55% in 2000, a share maintained since then. This figure rises to

nearly 70% when considering also the trade with the countries acceding to the EU in 2004. The most important trading partners are Italy, Germany and Austria. After a sharp fall by 1995, the share of trade with the other countries of the former SFRY has been increasing again, Slovenia and Bosnia and Herzegovina being the most important partners. The importance of CEFTA countries, excluding Slovenia, in Croatia's trade has been subdued. Trade with Russia and the rest of the former Soviet Union has been falling in the early stages after independence and has not recovered since; only imports from Russia (mainly oil) have increased. This perspective however neglects tourism which represents by far the most important economic sector for generating export revenues (*see also Part 3, Chapter 15 – Industrial Policy*).

Similar to other transition countries, Croatia's exports are characterised by a high share of labour- and capital-intensive industries and a low share of technology-driven industries. The most important export group is machinery and transport equipment reflecting shipbuilding, which gained weight over time and accounted for almost 30% of total exports in 2001. The same sector also plays a major role on the import side due to the high degree of imported inputs for shipbuilding. Other important sectors are manufactured goods including textiles and chemicals, albeit with a declining share. Agriculture plays a minor role in the export composition.

Structural Change

Croatia began the transition process from a favourable starting point. It was the second wealthiest of the Yugoslav republics with some good infrastructure, a developed tourism industry and established links with the West. It had industrialised before becoming socialist and it never adopted communist-style command planning. Entry into the market was not exclusively dictated by the state, and market prices prevailed in many areas. The existence of private enterprises in the ex-SFRY has been possible since 1988.

Since independence, Croatia has experienced a process of de-industrialisation albeit less severe than in other Eastern European countries. This process has slowed down after 1996. The importance of manufacturing, which accounts for some 71% of industry (including construction), has declined in terms of both share of GDP (21.6% in 2001) and employment (21.3% in 2001). Already high from the outset, the services sector, notably tourism, has further grown from about 50% of GDP at the time of independence to roughly 60%. The share of agriculture in GDP declined slowly in the second half of the 1990s but still stands above 9%, reflecting the slow restructuring in this sector and absorption of self-employment of people who lost their jobs in the manufacturing sector.

The system of public finances has long been a matter of concern, showing signs of increasing government interventions, a lack of transparency as well as poor reliability and delayed availability of fiscal data. A number of factors contributed to this unfavourable development: the lack of integration of sub-central government bodies, the creation of extra-budgetary funds and the accompanying lack of transparency (in granting and recording of state subsidies and government guarantees), poor control of the funds' expenditure, underdeveloped medium-term planning, insufficient rules and procedures of budget management as well as low accountability. Even though there is further room for improvement, a number of activities have been initiated in the past years: a single treasury account, including the development towards an accruals-based accounting method, and a new system of accounts have been introduced, extra-budgetary funds were integrated in the budget, reporting and monitoring requirements have been expanded and a new organic budget law was adopted in mid-2003.

Before 2000, the system of socially-owned enterprises and worker management meant that the distinction between owners, managers and workers was not clear: in most enterprises managers were appointed by the employees. In larger enterprises, the authorities nominated them. This led to wage escalation, over-employment and under-investment. Loss-making enterprises survived not so much because of government subsidies but because they accumulated arrears to other enterprises, and they had easy access to bank loans - which in turn undermined the health of the banking sector.

Privatisation in Croatia was based on two key laws: the Transformation Act of 1991, which covered a total of 3,000 *socially-owned companies* (with the exception of 10 large infrastructure and utility companies designated as public enterprises) and the Privatisation Act of 1993, amended in 1996. Since 1996, *public enterprises* are privatised on the basis of separate laws. Early privatisation policies often took the form of insider buyouts (management and employees), which did not facilitate the modernisation of corporate governance. After the exhaustion of insider priority rights, the second stage of privatisation (from 1993 onwards) shifted to public auctions and tenders, which were particularly successful after allowing the acquisition of shares against frozen foreign currency deposits²³. Voucher privatisation effectively started in 1998 but produced only short-term results until the economic crisis. The privatisation of public enterprises and other “strategic” assets (e.g. banks) not covered by the transformation and privatisation laws only started at the end of the decade under growing fiscal pressure.

Administrative price setting had not been a feature of the SFRY economic system. All direct price controls were removed after independence with some exceptions (wood, transport, postal services). Prices for energy and telecommunication are regulated by responsible bodies. Administrative prices also exist for public services on the local level. This situation still prevailed in 2003.

Until the late 1990s, the Croatian banking system was dominated by state-owned banks operating in an insufficient regulatory framework with weak supervision and vulnerability to political interference. The deterioration of the economic situation from 1997 onwards also exposed serious solvency problems in the banking sector, which resulted in a banking crisis in 1998/1999. Since then, the banking sector has been restructured and has consolidated. Supervision and capital requirements have been strengthened. Most of the sector has been privatised and is controlled by foreign banking groups. However, the process of rehabilitating and stabilising the sector was achieved at high costs: since 1991, EUR 5.6 billion was spent by the state on measures to rehabilitate the banking system, equivalent to 33% of the average GDP.

Fuelled by the armed conflict until 1995, there was evidence of the existence of a significant shadow economy in Croatia. However, a number of factors including the introduction of VAT in 1998, improvements statistical registration and the entry of foreign firms notably in the retail sector have contributed to a decline in the past few years. A study of the Croatian Institute of Public Finance of 2001 estimated the share of the grey economy at around 25% of

²³ Frozen foreign exchange deposits (FFED) originate from the right of former Yugoslav citizens to hold foreign currency accounts in domestic banks, which had to redeposit this foreign currency with the National Bank of Yugoslavia (NBY). After the break-up of the SFRY, the NBY retained these funds and the Croatian government decided to accept these assets as public debt. It issued bonds in 1991 to Croatian banks in exchange for their claims against the NBY and introduced a freeze on the deposits but allowed its use by citizens in the context of privatisation projects.

GDP on average for the period 1990-1995 and at around 10% for the period 1996 – 2000, based on the national accounts non-compliance method.

2.2. Assessment in terms of the Copenhagen criteria

The Existence of a Functioning Market Economy

The existence of a functioning market economy requires that prices, as well as trade, are liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy.

There is an increasing political consensus on the essentials of economic policy. Until 2000, Croatia followed a rather gradual approach to structural reforms and tried to establish consensus between the social partners. This helped to preserve social stability but it also delayed necessary reforms. When coming into office in early 2000, the Croatian government adopted a medium-term strategy and subsequently refined its developmental priorities. Over the past years the focus for policy has shifted from general macroeconomic stabilisation to fiscal consolidation and structural adjustment. The aim has been to boost competitiveness and to create employment through a dynamic implementation of structural reforms. The economic and financial policies have been supported inter alia by two precautionary Stand-by Arrangements with the IMF and a Structural Adjustment Loan (SAL) from the World Bank. Discussions with the IMF are underway on a new programme following the expiration of the second Stand-by Arrangement. The Economic and Social Council has been established as a consultative body consisting of representatives of the government, the employers and trade unions, which however did not always achieve an agreement on the discussed areas. In a resolution on the accession of Croatia to the European Union supported by all represented parliamentary groups, the Croatian Parliament stated in December 2002 that Croatia's accession to the European Union is a strategic national goal, which is according to polls shared by the vast majority of the population. In accordance with this goal, the objectives of economic policy have been laid down in the first "National Programme for the Integration of the Republic of Croatia into the European Union" adopted by the Croatian Government in December 2002. There also seems to be an increasing awareness of and commitment to improving the co-ordination between policy departments to achieve these objectives. Co-ordination bodies exist or have recently been set up on economic issues within the government, between the Ministry of Finance and the Croatian National Bank and between the main providers of statistical information. Despite the existing formal framework for co-ordination, further improvement in its actual implementation seems necessary.

GDP growth recovered to relatively high rates after the recession in 1999. Since 1996, Croatia achieved an average growth rate of 3.7% despite the recession in 1999 when the economy contracted by 0.9%. Over this period domestic demand, in particular private consumption, which was partly credit-driven, was the main driving force of growth, with government consumption playing a minor role after 2000. The contribution of investment to growth (mainly through government initiated road and housing construction investment) has picked up again after 2000, when government investment turned positive, and is currently growing at a higher pace than private consumption. After three years of de-stocking, 2002 showed an increase of stocks. Even though the current account has been negative since 1996, the contribution of net external demand to growth was positive in the period 1998-2000. Given the reasonably high investment share (24.8% of GDP in 2002), declining government deficits and domestic-driven growth, Croatia should demonstrate a fairly good resilience to

external shocks. However, the continuous growth of the external debt, the rather large current account deficits as well as the dependence of the current account on tourism and the limited room for manoeuvre in fiscal policy represent vulnerabilities.

Since 1996, the trade balance and the current account show rather high deficits. The merchandise trade deficit declined in the period of economic slowdown but widened again with the economic recovery after 1999. On average, the merchandise trade deficit reached 20.2% of GDP over the period 1996 to 2002, and 23.55% in 2002. This reflected strong domestic demand, based on private consumption and government funded construction programmes, and, more recently, the economic slowdown in the main trading partner, the EU. The growth of imports outpaced exports throughout the period with the exception of the years 1998/1999. Tourism, which recovered in particular after the Kosovo crisis, is the most important export product and thus plays an important role as an external revenue source for Croatia, although it also creates import demand. Compared with the merchandise trade balance, the deficit of the balance of goods and services is therefore considerably lower (8.7% of GDP in 2001 and almost 12% in 2002). The current account balance averaged 6.3% of GDP over the period 1996 to 2002, and 7.1% in 2002, but shows an erratic development over the years. Available data suggest that the past features - widening merchandise trade deficit and further improved tourism income - continued in 2003 even though the current account deficit is expected to be below the average of the period 1996-2002. However, frequent revisions in the past underline the need to improve the reliability of balance of payments data.

The current account deficits have been financed by foreign borrowing and foreign direct investment. After having signed debt restructuring agreements with the Paris and London Clubs by 1996, Croatia gained access to the international markets and borrowed at increasingly favourable terms (mostly in the form of euro bonds) thanks to its improved credit rating. As a consequence, the external debt stock increased from 26.7% of GDP in 1996 to 68.5% of GDP in 2002, increasingly nurtured by private borrowing abroad (the external public debt represents roughly 32% of GDP of which approximately one third originates from external debts incurred by the SFRY). Under the IMF programme, administrative steps have been taken by the HNB to curtail the strong growth of the external debt, which however is estimated to have increased further to some 72% of GDP by the end of 2003. FDI increased from 1995 and in particular from 1998 onwards, driven to a large extent by privatisation. Net FDI inflows reached €1.15 billion in 2000 and €1.57 billion in 2001, but declined to €384 million in 2002. On average FDI corresponded to 5% of GDP in 1996 to 2002; for 1999-2001 FDI inflows more than covered the current account deficits.

Unemployment remains high but there are signs of a gradual easing of the situation. Rising unemployment was a constant phenomenon in Croatia since the beginning of the 1980s and until 2001 employment did not increase despite economic growth. There are several reasons for the still high unemployment: the entry of persons from liquidated companies and companies in bankruptcy not fully compensated by new job opportunities, wage growth on average slightly above productivity growth, a rather high burden of social contributions and a high labour market rigidity (reflected in high procedural and monetary costs associated with individual dismissals, restrictions on temporary employment, high costs of collective dismissals). However, the trends of declining activity and employment rates as well as increasing unemployment seem to have reversed in 2002. The strong economic growth, some systematic changes and data consolidation resulted in a continued fall of the official unemployment rate since 2002 until September 2003 when unemployment started to slightly increase. In November 2003, the official rate stood at 18.9%, 2.7 percentage points lower than in November 2002. Official data are likely to overestimate the unemployment since they do not take into account employment in the grey economy. The unemployment rate according to

ILO methodology declined to 14.1% in the first half of 2003 (average rate in 2002: 14.8%). Employment as a share of the population of working age constantly fell from some 50% in 1996 to 41.8% in 2001 before it slightly recovered to 43.3% in 2002. Furthermore, from 2001 the government has begun to implement several programmes to facilitate employment in line with the National Employment Action Plan, the guiding document for an active labour market policy. Finally, amendments to the labour law (including more limited rules on severance pay), were adopted in mid-2003 aiming at increasing flexibility in the labour markets.

Croatia has been successful in maintaining low inflation rates. The exchange rate of the kuna against the euro is the main nominal anchor of price stability and the main indirect objective of monetary policy. This is explained by the high degree of currency substitution, the high trade integration with the EU and the pronounced and increasing role of the euro in the currency structure of external trade. This policy has succeeded in achieving single-digit inflation rates since 1995. Between 1996 and 2002, the average retail price inflation, currently the main indicator in the absence of a Consumer Price Index (CPI), was 4.3% (annual average), and 2.2% in 2002.²⁴ Inflation rates have remained subdued during the first eleven months of 2003 averaging 1.5% compared to the same period in 2002. The effectiveness of orthodox instruments of monetary policy has however been limited. The past structural excess liquidity coupled with a weak payments system and liquidity management practices of banks have hampered the development of money markets and interest-sensitive monetary instruments. Against this background, the HNB decided in early 2003 on a set of administrative measures so as to curb the externally funded domestic credit growth, which threatened to worsen the external position as well as the stability of the banking sector. These measures expired at the end of 2003. Although the administrative measures have slowed down credit growth, the external debt further increased during 2003 due to direct borrowing abroad and leasing operations. In response to further monetary tightening by the HNB, money market interest rates rose in the fourth quarter of 2003, which –if continued- might have implications for the public debt service.

The exchange rate of the kuna against the euro has remained in a rather narrow band. Since 1994, the HNB implements an exchange rate policy classified as "managed floating", i.e. the HNB aims to soften exchange rate movements of the kuna against the euro, which usually follow a seasonal pattern of appreciation during the summer tourism season and subsequent depreciation. This policy has resulted in a rather stable nominal exchange rate, which de-facto fluctuated within a band of +/- 6% around the average exchange rate in the period since 1994. In recent years, the kuna exchange rate vis-à-vis the US-dollar has been following the movements of the euro towards the US-dollar impacting on external indicators expressed in this currency. However, nominal and real effective exchange rate indicators showed a depreciation trend in the period 1996 up to 2000 and appreciation tendencies thereafter.

The budget deficits have been curtailed from high levels but progress has stalled in 2003. According to IMF data, the general government deficit widened significantly to 8.2% of GDP in 1999, partly financed by an increase in arrears of government agencies to public and private enterprises of 0.8% of GDP (totalling 5.9% of GDP). It then declined to 6.5% in 2000 and 6.8% in 2001 with the settlements of arrears contributing negatively to financing. In line with the adjustment policy under the IMF monitored Stand-by Arrangement, the deficit was further reduced to 4.8% of GDP in 2002. The deficit was originally estimated to be reduced to 4.6% in 2003, on the basis of a reduction of the high public wage bill through a wage freeze

²⁴ Core inflation, which excludes agricultural products prices and administrative prices from the retail price index, averaged 3.4% in the same period. Producer price inflation was even lower at 2.6%.

and through a reduction of public employment and of benefits and allowances. However, public spending considerably exceeded planned expenditure in the last quarter of 2003, also due to last minute public sector wage increases, and the deficit in 2003 exceeded 5% as a result. The transparency and structure of public expenditure has substantially changed over time and its share in GDP is being gradually lowered (50.0% in 2002). Extra-budgetary funds, notably for pensions and the health sector, have been gradually integrated into the budget. As part of a general decentralisation move, public functions and revenue proceeds have been transferred to local government levels (between 2000 and 2002 the share of revenues of municipal, town and county budgets increased from 5.7% of GDP to 7.1%). There have, however, been problems in providing appropriate administrative capacity. Croatia was able to access the international markets to fund its reconstruction process in the post-war era. In combination with high privatisation proceeds and the favourable revenue development this weakened budget constraints and led to rather high general government budget deficits, caused in part by a high public sector pay bill, and the accumulation of public debt. In 1999, the economic and financial crisis significantly worsened public finances. In the period from 1996 to 2002, total revenues as a share of GDP peaked in 1999 at 48.4% and declined to below 45.2% of GDP in 2002 including the reduction of the tax burden in 2000 and 2002. Total expenditure peaked at 56.6% of GDP in 1999 after which it fell to about 49.5% in 2003. As a consequence, the general government debt increased rapidly from 31.6% of GDP in 1997 to 51.6% of GDP in 2001. This ratio has since then been maintained. The primary deficit deteriorated to peak at 6.5% of GDP in 1999 after which the negative trend was reversed and the primary deficit was reduced to 2.7% in 2002. So as to ensure long-term sustainability of public finances, the social security system is undergoing amendments. A modern pension reform introducing a three-pillar system is being implemented since 2002. The eligibility criteria for unemployment benefits have also been strengthened. However, the health sector reform is still at an early stage and experience with the introduction of supplementary insurance schemes was mixed. The new budget law adopted in 2003 will improve the budget management and require the establishment of a medium-term fiscal framework. Together with the introduction of the Single Treasury Account and of the new system of accounts, this should contribute to improving the quality, scope and regularity of fiscal statistics, which have been weak so far.

The policy mix has improved since 2000 when fiscal policy became oriented towards macroeconomic stability. In the late 1990s, monetary policy had to bear the main burden of ensuring macroeconomic stability as fiscal policy became increasingly expansionary. After 2000, fiscal policy gradually contributed to a stable macro-economic environment with expenditure being cut, including the reduction of the public wage bill and the restructuring of expenditure towards capital expenditure, although this process stalled in 2003. In general, fiscal policy allowed the easing of monetary policy without jeopardising price stability during this period. Albeit declining, the general government sector accounted for far more than half of the domestic saving-investment gap in 2002. However, since the government continues to rely on external financing to a significant extent, the conversion of funds for domestic use needs to be closely co-ordinated so as not to jeopardise monetary policy.

Price liberalisation is advanced but administered prices continue to play a role. In 2003, the share of administered prices in the retail price index amounted to 23% but increased over the past three years by 4.8 percentage points. This reflects the increased weight of these prices (mainly public utilities, telephone, energy and electricity), which are annually adjusted but not an increase in the number of administrative prices. The prices of goods and services are liberalised with the exception of some economic activities for which prices are administratively controlled on a national or local level, notably for certain agricultural

products and for public transport, basic community and postal services. The price control system in the areas of energy and telecommunications is currently being replaced by regulatory bodies in line with the on-going liberalisation of the sectors; most of these regulatory bodies are however not yet operational (*see Part 3, Chapters 14 - Energy and 19 – Telecommunications*).

Although withdrawing, the state is still predominant in several sectors of the economy. In the period 1993-1999, the private sector share in GDP doubled from 30% to 60% but has stagnated at this comparatively low level. In 2001, 71.3% of total tangible assets were in public ownership, which represents even an increase by 6.1 percentage points compared to 1999. Apart from usual public areas like education, health, postal and community services, other economic sectors with a high public ownership of tangible assets are agriculture, public utilities, transport and real estate; even in the manufacturing industry (through shipbuilding) the public share accounts for a third of total tangible assets. As a result of the motorway construction programme, public ownership in construction stood at 90%. On the other hand, tangible assets of financial intermediation (99.9%), reflecting the almost completed privatisation of the banking sector, and trade (93.1%) were almost entirely in private ownership already in 2001. Privatisation is well advanced in telecommunications, although market opening has proceeded slowly. The monopoly of the fixed line service formally ended at the end of 2003. There are two mobile network operators, but a third license should be considered in order to enhance competition. However, the private sector showed more dynamics than public enterprises in terms of revenue growth as well as the profitability in the period 1996-2001. Revenue growth of private enterprises exceeded nominal GDP growth and their share of total enterprise revenues rose from 58.4% to 67.8%.

Privatisation has progressed but encounters frequent legal and political problems. After taking office in 2000, the new government consolidated state holdings under the Croatian Privatisation Fund (HFP) but there are still assets with the Bank Rehabilitation Agency and the pension and health funds. In the period January 2000 to December 2002, the state portfolio was reduced from 1,860 to 1,056 companies, mainly through the sale of minority shares, but was at roughly the same level as of August 2003. The number of companies in the portfolio constantly changes due to the cancellation of past share acquisition agreements. In mid 2003, there were still 170 companies with a majority state share in the portfolio whereas the state held less than 25% of shares in 822 companies. There is still a high state ownership of tourist entities; part of which were tendered but have not found much interest due to the high investment needs and the degree of indebtedness. In mid-2003, the government adopted a proposal to redesign the competencies of the HFP for completing the privatisation, but this proposal is still in parliamentary procedure and has effectively discouraged the preparation of new privatisation projects. Given the important role of the line ministries in initiating and approving privatisation projects, it remains questionable if the new system will accelerate procedures. The privatisation of agricultural conglomerates was initiated in late 2002 and encounters significant problems due to the generally poor status of the land registry and the cadastre, which impede the establishment of effective land and housing markets. As of 2001 (the latest data available), some 87% of tangible assets of agricultural land and housing were still in public ownership. More generally, large, often formerly public or socially-owned, firms still play an important role in Croatia's economy. A number of enterprises continue to have exclusive or special rights in certain aspects even though steps are being taken to liberalise sectors such as telecommunications, electricity and oil. Public enterprises are privatised according to special laws. A majority stake of 51% in the telecommunications company was sold to a foreign investor but the government postponed the envisaged offer of further stakes. A first step in the privatisation of the power supply sector was taken by selling

a 25% share of the oil company INA in summer 2003. The privatisation of the distribution network of the electricity company has been delayed. Two tenders to privatise the biggest insurance company were cancelled and the government decided to retain a majority shareholding.

Even though the authorities have started several initiatives, there remain barriers to market entry and exit. In the period 1999 to 2001, the overall number of enterprises in the manufacturing and services sectors declined by almost 3% reflecting some consolidation as well as the impact of the economic slow-down in 1998/1999. Both the number of newly created enterprises as well as the net increase in the total number of enterprises recovered after 2000. However, enterprises are still confronted with relatively high costs, a substantial burden of administrative regulations, difficulties in access to finance, in particular long-term maturity, and domestic markets dominated by a few business groups with a low level of competition. Another factor was the rigidity of the labour law, which however has been partly addressed by the amendments adopted in 2003. Despite some time limits for particular steps, overall procedures to set up a business are lengthy and vary between regions: according to the Global Competitiveness Report 2002-2003 by the World Economic Forum, it takes an average of 51 days to start up a firm in Croatia, which is considerably longer than in many developed economies. A one-stop shop does not yet exist. The Croatian authorities have started a comprehensive initiative to implement the findings of the FIAS²⁵ study on administrative barriers to foreign investment (January 2001). In particular, an action plan was adopted in February 2002 listing detailed measures of short and long-term nature; however its implementation record is mixed. The laws and procedures regulating bankruptcy were introduced in 1997 and the Bankruptcy Act was amended in July 2003. As is the case for court procedures in general, bankruptcy procedures have been lengthy and suffer from the weaknesses of the judicial sector. This is illustrated by the privatisation process. Among the companies that had undergone transformation and privatisation since 1991, 728 have been sent into bankruptcy, but bankruptcy proceedings have been completed only in 177 cases. The amendments to the Bankruptcy Act create the legal base to simplify proceedings and to accelerate procedures, inter alia by introducing timeframes, which however need to be implemented.

*The legal framework is being harmonised with the *acquis communautaire* at a high speed, but the effectiveness of the judicial system is still unsatisfactory.* Already in autumn 2001, the authorities adopted an implementation plan for the Stabilisation and Association Agreement so as to harmonise Croatian law with the *acquis*. In summer 2003, a number of important laws in the economic area were adopted including bankruptcy, company, foreign exchange and labour law. The challenge will be to ensure effective implementation and enforcement of this legislation inter alia through improving the capacity of the public administration. However, the courts system does not function well and does not effectively enforce creditor and property rights. Procedures are slow and there continues to be a substantial backlog of cases. Legal interpretation within the courts system varies, the administrative and professional capacity is low and there is a lack of support staff and of a professional training system. The cadastre and land registry are in a poor state, which also reflects the often outdated and insufficient technical equipment of courts. The authorities are aware of the problems and are implementing a number of projects together with international donors to improve and modernise the capacity and efficiency of the courts. The situation is however unlikely to improve substantially in the short term. (See also Part I, *Political Criteria*.)

²⁵ Foreign Investment Advisory Service, which is a joint service of the International Finance Corporation (IFC) and the World Bank.

The financial sector is sufficiently developed to channel savings towards productive investment but credit expansion to corporate customers suffers from the weak judicial sector. The privatisation of the Croatian banking sector is almost complete with only two commercial banks accounting for 4% of total banking assets still in majority state ownership. Foreign banks control more than 90% of total banking assets. From the beginning of 2004, the Croatian banking sector comprises 42 banks essentially dominated by 6 banking groups, as well as 4 housing savings banks and 1 savings bank. The two leading banking groups account for roughly 49% of total assets. In addition, 115 savings and loans cooperatives were in operation in 2002, but they represented only a small part of total assets. The entry of foreign banks has resulted in a widened range of products and services provided by Croatian banks as well as intensified competition. This is reflected in the spread between average credit and deposit interest rates having fallen from 10.1% in 1998 to 6.5% in 2001. A change in methodology as of 1 January 2002 (the government sector and financial institutions are no longer included in the interest rate statistics) resulted in a one-off rise in the spread between average interest rates, most notably for activities not indexed to foreign currency, which stood at 9.6% at the end of 2002. Private banks have been allowed to operate payments systems, formerly carried out exclusively by the Central Payments Institution (ZAP) inherited from the former Yugoslavia. Currently, 11 banks perform payment system functions and account for about 60% of daily transactions. Ample liquidity, streamlined loan approval procedures and reduced interest rates have made access to credit easier. Total domestic loans (both in kuna and foreign currency) as a percentage of GDP increased from 27.9% in 1996 to relatively high 55.2% at the end of 2002. The share of private sector credit slightly declined in the past years but accounted for some 88% of total lending, representing some 48.9% of GDP. Credits to enterprises recovered in the past two years after the recession-induced decline in demand in 1999: total loans corresponded to 26.6% of GDP at the end of 2002, thus reaching again the level of 1998. The difficulties of using immovables as collateral, as well as the long bankruptcy proceedings, undermine a sufficient protection of creditor and property rights and affect lending. In combination with the perceived higher profitability of household lending and the lack of access of households to direct foreign borrowing, this has resulted in a weaker credit growth to enterprises than to households, which however often include crafts and micro-enterprises. Foreign ownership facilitated the high credit growth through the availability of funds from the parent companies but the growth raised concerns about the impact on the quality of banks' credit portfolios and contributed to the rise of external debt. Even though medium- and long-term maturity loans are increasingly available (10-15 years for legal entities and 25-30 years for mortgage loans), 40.9% of the total loans to the private sector are shorter than one year and the average maturity of bank loans has hardly changed since 1999 (2.7 years as of 31 March 2003 compared to 2.5 years at the end of 1999).

The non-banking financial sector is less developed. In terms of assets, the non-banking sector accounts for some 12% of total assets of the financial sector pointing to the still limited size of financial services other than banking. The insurance sector is small but highly concentrated, and a broad range of products is available. In 2002, 24 insurance institutions operated in Croatia of which 13 were domestic (achieving a gross written premium of 3.2% of GDP). The largest insurer had a 46% market share while 5 other companies had a share of 5-10% each. Even though two stock exchanges exist (in Zagreb and in Varazdin), the capital markets are neither deep nor liquid and the acquisition of Croatian companies by foreign investors has further reduced the number of listed companies. Total market capitalisation of both exchanges totalled some 30% of GDP at the end of 2002. The listing requirements for enterprises introduced in 2003 are unlikely to result in higher trading. The establishment of pension funds has had a sizeable impact on the turnover and trading volume, in particular of bonds. As of

September 2003, the 5 compulsory and 4 voluntary pension funds in Croatia were showing strong growth of assets. (See also Part 3, Chapter 3 – Freedom to provide services.).

The stability of the banking sector has improved but the high euroisation remains a potential vulnerability. The HNB is the institution in charge of issuing bank operating licences and supervising bank operations. Following the 1998 crisis, the banking sector has been stabilised and continues to consolidate. The professional management of a crisis in 2002 contributed to growing confidence in the banking system, which is also reflected by the growth in bank deposits, in particular the deposit of foreign exchange cash into bank accounts in the context of the physical changeover to the euro in the euro area. Already in 1997, a deposit insurance system was introduced. According to indicators from the HNB on non-performing loans, capital adequacy and primary liquidity ratio of banking institutions, the profitability and soundness have improved. In 2003, the HNB took a number of measures, which managed to slow down credit growth. It remains to be seen whether the recent growth of lending activity, in particular to private households, will have an impact on the credit quality. Foreign currency indexation remains an important feature, which increases the vulnerability of the banking system: foreign currency deposits including those denominated in and indexed to foreign currencies correspond to 88.5% of total deposits, albeit at a modestly declining trend. 78% of bank loans are denominated in or indexed to foreign exchange whose borrowers receive kuna-denominated income and/or do not have access to hedging instruments. Even 70% of the domestic Government bonds in kuna is indexed to the euro exchange rate.

The Capacity to Cope with Competitive Pressure and Market Forces

The ability to fulfil this criterion depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to make decisions in a climate of predictability. It also requires a sufficient amount of human and physical assets. State enterprises need to be restructured and enterprises need to invest to improve their efficiency. Furthermore, the more access enterprises have to outside finance and the more successful they are at restructuring and innovating, the greater will be their capacity to adapt. Overall, the more an economy is integrated with the Union before accession, the better will it be able to take on the obligations of membership.

Croatia has achieved a sufficient degree of macroeconomic stability to allow economic operators to make decisions in a climate of stability and predictability. Following the economic crisis in 1998/1999, Croatia has established a solid track record of macroeconomic stability. Enhanced economic stability and structural reforms undertaken so far permit the working of market mechanisms, although government interventions continue to take place. This creates the basic conditions for coping with competitive pressures. The remaining challenges are to continue the fiscal consolidation and privatisation, to widen and deepen the development of the financial sector and to improve the business environment, notably through enhancing the performance of the judicial sector.

The labour force is rather well educated but labour force participation is low. Despite its improved macroeconomic productivity, Croatia suffers from a large share of economically inactive population (the activity rate was at 50.9% in 2002) and demographic challenges (as of June 2003, the ratio of pension fund contributors to beneficiaries stood at 1.4). The productivity level of Croatia in terms of income per capita is at 21% of that of the EU in nominal terms and at 35.9% in PPP terms. Productivity developments vary between sectors and branches but available data suggest a better performance of the service sector than of industry and agriculture. In general, the shift of enrolment to secondary and higher secondary education suggests that the education level of the working age population has increased over

the years since 1996. However, the share of persons with a university degree fluctuated between 10.7% and 13.4%. This perspective leaves aside the need to modernise the quality of education and curricula (*see Part 3, Chapter 18 – Education*). According to government records, roughly 1,050 students are enrolled in universities abroad. Compared to the EU average, Croatia shows a higher share of population (aged 25-64) with secondary education and lower shares for both elementary school and higher-than-secondary education. In 2002, the Employment Promotion Programme was adopted. It aims at reducing unemployment and at fostering employment of specific target groups e.g. through support for university-leavers and former military staff. (*See also Part 3, Chapter 13 – Social policy and employment.*).

Croatia is investing in improving its infrastructure and has achieved relatively sound and stable investment rates. In the period 1996 to 2002, the investment-to-GDP ratio reached on average roughly 23%, with a peak of 24.8% in 2002, of which more than 70% were private investments. Nominally, FDI has been an important contributor to investment and growth in this period: FDI inflows corresponded to an average 5% of GDP. However, almost two thirds of FDI were related to privatisation projects as reflected by the main sectors benefiting from FDI: telecommunications, financial intermediation and the pharmaceutical industry. Greenfield investment accounted only for 16.4% of the total. The main domestic sectors of investment were manufacturing, trade, transport and construction, reflecting large government investment in roads and reconstruction. Even though capacity seems to satisfy current needs except during the main tourist season, the quality of transport infrastructure is perceived as unsatisfactory by entrepreneurs. In the period 1996-2002, investment in roads, in particular for the construction of new motorways, reached a high level. At the same time investment in railway infrastructure remained modest, but is planned to pick up in the framework of a 4-year programme. Telecommunications improved significantly: the fixed line network is fully digitalised and there are two operators for mobile telephony resulting in a mobile penetration of 56% as of June 2003. The implementation of regulatory reforms and the introduction of competition are however still lagging behind in some infrastructure sectors including in telecommunication. Gross domestic R&D expenditure amounted to an annual average of 0.96% of GDP over the period 1997-2001, rising through the period, which is relatively high but still below the EU average (2.21% in 2000). This also applies to R&D per capita and the business sector share of R&D.

Over the period 1996-2001, the share of manufacturing and agriculture decreased somewhat while the traditionally strong service sector gained further strength. Manufacturing declined modestly from 22.3% of GDP (constant prices) to 21.5%. Within manufacturing, activities with low value added tend to dominate the industrial structure, partly as a consequence of the past privatisation policies. Similarly, agriculture contracted over time from above 10% but is still high at 9.1% of GDP (constant prices). This sector is dominated by small, dispersed individual farms and big conglomerates, which are in the process of being privatised. Productivity and efficiency are low and there is significant need for adjustment. This could lead to a fall in agricultural employment, which is still important. The trade sector increased considerably since its low in 1998 but is still below the levels of 1996/1997. Trends in employment followed the same pattern.

After a slow start, enterprise restructuring has made some progress. Following the adoption by the government of a programme to speed up restructuring and privatisation in early 2001, there has been some progress in restructuring. The former Croatian Post and Telecommunications was separated in two joint-stock companies in 1999 of which the Croatian Telecom has been partly privatised. By mid-2003, 30 companies had been restructured and 20 companies were undergoing restructuring. The restructuring of the railways is starting. Even though there is no global plan of company restructuring, the

government adopted programmes for restructuring shipbuilding and the agro-industrial conglomerates, which have benefited from high subsidies and government interventions. Moreover, a restructuring plan for the steel sector is in preparation. Arrears have been reduced to a large extent and were estimated to be below 0.2% of GDP in mid-2003, which is however unlikely to capture the entire public sector (e.g. the health sector). (See Part 3, Chapter 15 – Industrial Policy.).

The share of small firms in GDP and employment increased even though their total number declined. Small and medium-sized enterprises (including crafts, co-operatives and micro enterprises) account for 99.6% of all enterprises and 65.7% of employment by enterprises (as of June 2003). In the period from 1996 to 2000 the number of small companies declined by 8.9% although their employment increased in absolute terms (by 6.8%) and also as a percentage of total employment (by 3.2 percentage-points). The opposite was the case both for medium-sized and large enterprises. The SME share in GDP is estimated at roughly 55%. SMEs tend to suffer more from barriers to market entry and weaknesses in the business environment. Prominent among these are difficulties in getting access to finance due to problems providing collateral and the lack of SME credit assessment skills in the banks, competition from subsidised state-owned enterprises, lack of entrepreneurial knowledge and weaknesses in the institutional infrastructure, notably in the judicial sector and in the public administration. The authorities have been making efforts to improve the situation, and the increasing numbers of newly created enterprises seem to signal some improvement. A separate ministry was created after 2000, which implemented a number of initiatives to improve the situation of SMEs but has been reintegrated into the Ministry of Economy after the elections in November 2003. The government also adopted a Development Programme for Small Entrepreneurship 2003-2006 and signed the European Charter for Small Enterprises, which sets out principles for improving the business environment for SMEs. Co-ordination between different government levels in terms of SME policy and the communication between the authorities and the business community could still be intensified. (See Part 3, Chapter 16 – SMEs.).

The level of state aid and support to specific sectors is still considerable while transparency remains low. There was a track record of increasing open and hidden government interventions before 2000. In the last three years, efforts have been made to prioritise the field of state aid control legally and materially. A "Plan of Action regarding the Subventions in the Economy" was prepared in 2001 and its implementation monitored through the SAL-programme with the World Bank, resulting in a gradual decrease of state support in terms of GDP. Criteria for granting state guarantees are being introduced and the net outflow declined in the past years but guaranteed amounts more than doubled in 2002 compared to 2000. According to the authorities, in the period 2000-2002 the average state support was 3.5% of GDP and showed a declining trend but this refers only to direct subsidies from the central budget. More comprehensive academic estimates that include other forms of state aid suggest higher levels. The legal and institutional framework in the field of State aid only dates from 2003. Croatia will not only have to reduce the overall level of state aid but also the level for particular sectors (like agriculture, transport, shipbuilding, tourism and, more recently, railway) in favour of horizontal support. (See Part 3, Chapter 6 – Competition.).

Croatia has substantially liberalised its trade over the past years. Successive trade liberalisation measures since 1993 brought about considerable improvements but progress in actual trade integration with other countries was limited by Croatia's political isolation until early 2000. Since then, Croatia has made rapid progress: it joined the WTO (November 2000) and concluded a number of bilateral free trade agreements (FTAs) including with the EU, neighbouring countries and EFTA. As of 1 March 2003, Croatia's membership in CEFTA has

been effective. As a result of these agreements, the weighted average tariff rate for industrial products applied to most-favoured nations stood at 3.5% at the beginning of 2003. Being a small open economy, Croatia's total trade-to-GDP ratio (goods and services) was at 103.7% in 2002. (*See Part 3, Chapter 26 – External relations.*)

Croatia's economy is already highly integrated with the Union. The EU is by far Croatia's most important trading partner, with average export and import shares of 52.6% and 56.2% respectively for the period 1999-2002. This share will increase in the order of 13 and 15 percentage points respectively through the accession of ten new EU Member States as of 1 May 2004. In 2002, Croatian exports to the EU amounted to €2.74 billion while imports reached €6.32 billion. The merchandise trade balance shows a high and increasing deficit: whereas exports grew by a modest 7% in 2002 compared to 1996, imports grew by 26% resulting in a 51% surge of the merchandise trade deficit and a deterioration of the import-export coverage from 57% to 48%. As a consequence, Croatia's share of total EU imports declined (from 0.4% in 1993 to 0.2% in 2002) while Croatia's share of total EU exports remained stable (at 0.7%). A number of factors contributed to this development. The structure of Croatian merchandise exports developed relatively unfavourably between 1995 and 2000, partly as a result of the continued domination of former and current public enterprises (in particular shipbuilding with large import components). The share of labour-intensive industries including textiles, footwear, wood and shipbuilding grew, partly due to the importance of outward processing trade, whose value added tends to be lower and which are more vulnerable to price competition. Furthermore, the improved market access for Croatian enterprises through the network of FTAs will need more time to bear fruit. Trade integration with the EU is also hampered by the fact that Croatia is not yet integrated in the pan-European system of diagonal cumulation of rules of origin. Given the relatively high labour costs, the Croatian economy will require further restructuring towards export specialisation in more technology-driven industries in order to compete successfully on the single market, as well as improvements in the business environment. A Trade and Investment Promotion Agency was founded at the end of 2002 in order to support export activities in particular of SMEs but it has not yet become operational. As regards Croatia's competitiveness in services, tourism revenues increased by almost 90% in the period 1996-2002 and the sector already accounts for 17% of GDP. Tourism is likely to grow further provided that privatisation of facilities takes place leading to more investment.

Labour productivity has significantly improved but is lagging behind the EU average. According to Croatian data, the increase of real GDP of 39% in the period 1993-2001 and the decrease of employment of 8% produced a growth in labour productivity (real GDP per employed person) of 50%, or 5.2% on an annual average. The growth of productivity was considerably faster in the services sector than in industry and agriculture. Almost none of the industrial sectors show an increase in employment when comparing the year 2002 with 1997; in fact, most show a significant decline. In 2001, labour productivity of Croatia stood at approximately 25% of the EU average in current exchange rates and at almost 40% when expressed in PPP terms. The productivity of industry is slightly higher than total productivity (respectively 27% and 44% of the EU level). The average unit labour cost is high and close to the EU average (97%), thus ruling out a competitive advantage in labour costs. However, none of the external competitiveness indicators provides evidence of a relative deterioration of Croatia's position since 1995 compared to its main trading partners and other transition countries. Assessments on competitiveness and the fragility of external balances suggest that structural reforms in the enterprise sector are needed to enhance Croatia's competitiveness.

2.3. General evaluation

Croatia can be regarded as a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its reform programme to remove remaining weaknesses.

In Croatia, there is an increasing political consensus on the essentials of economic policies. The Croatian economy has achieved a considerable degree of macroeconomic stability with low inflation. Enhanced economic stability and structural reforms undertaken so far permit the working of market mechanisms. This holds in particular for the liberalisation of prices and trade as well as for privatisation, albeit to a lesser extent. Croatia is characterised by a relatively well educated labour force and good road transport and telecommunication infrastructure. The country has a well developed banking sector and a competitive tourism industry. Croatia's economy is already well integrated with that of the EU.

However, the working of market mechanisms still needs some improvement. In particular, the performance of the judicial sector needs to be enhanced and high administrative burdens as well as incomplete systems of cadastre and land registry need to be addressed. Enterprise restructuring and privatisation has been slower than expected and some large state and formerly socially-owned enterprises still play an important role in the economy. In particular the shipbuilding and agriculture sectors need to be modernised. The necessary reforms of the fiscal and social security systems as well as the public administration are not yet completed and fiscal consolidation needs to be vigorously pursued. Full integration in the single market and the adoption of the *acquis* would, at this stage, cause difficulties for a number of sectors in withstanding the competition within the single market. Addressing the identified weaknesses should contribute to higher investment and growth, thereby enhancing Croatia's competitiveness.

3. ABILITY TO ASSUME THE OBLIGATIONS OF MEMBERSHIP

The European Council in Copenhagen in June 1993 included among the criteria for accession "the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union".

In applying for membership on the basis of the treaty, Croatia has accepted without reserve the basic aims of the Union, including its policies and instruments. This part of the Opinion examines Croatia's capacity to assume the obligations of membership – that is, the legal and institutional framework, known as the *acquis*, by means of which the Union puts into effect its objectives.

With the development of the Union, the *acquis* has become progressively more onerous, and present a greater challenge for future accessions than was the case in the past. The ability of Croatia to implement the *acquis* will be central to its capacity to function successfully within the Union.

In this regard, alignment with the *acquis* is a necessary but not sufficient condition to meet the obligations of EU membership. Croatia must also take all necessary measures create the necessary implementing structures, to bring its administrative and judicial capacities to the required level and to ensure effective enforcement. An analysis and assessment of Croatia's administrative and judicial capacities is therefore incorporated into each of the chapters analysed below.

This section follows the structure of the 29 negotiating chapters into which the *acquis* has been divided for the purpose of the previous accession negotiations. Each chapter examines the current and prospective situation of Croatia. The starting point of the description and analysis in each chapter is a brief summary of the *acquis*, with a mention of the provisions of the Stabilisation and Association Agreement or Interim Agreement, where they are relevant. Finally, for each chapter there is a brief assessment of Croatia's ability to assume the obligations of membership on a medium-term horizon. For the purpose of this Opinion and without prejudging any future date of accession, the medium-term horizon in the prospective assessment has been defined as a period of five years.

Chapter 1: Free movement of goods

The principle of the free movement of goods implies that products must be traded freely from one part of the Union to another. In a number of sectors this general principle is complemented by a harmonised regulatory framework, following the “old approach” (imposing precise product specifications) or the “new approach” (imposing general product requirements). The transposition of harmonised European product legislation represents the largest part of the *acquis* under this chapter. In addition, sufficient administrative capacity to apply horizontal and procedural measures in areas such as standardisation, certification and market surveillance is essential. This chapter also covers detailed EU rules on public procurement, requiring specialised implementing bodies.

The *Stabilisation and Association Agreement / Interim Agreement* contains a number of obligations in the field of the free movement of goods, such as the establishment of a free trade area. It also provides for the gradual alignment to Community technical regulations and standards as well as metrology, accreditation and conformity assessment procedures and the gradual opening of public procurement markets.

In the area of **horizontal and procedural measures**, in October 2003 Croatia adopted new legislation on standardisation and legal metrology. Gradual harmonisation with the principles of the *New and Global Approach* has also been sought by adopting new laws on technical requirements for products and conformity assessment, general product safety and accreditation in September 2003. These new acts will allow for the separation of the relevant functions of the State Office for Intellectual Property, Standardisation and Metrology, which is currently responsible for standardisation, conformity assessment, accreditation and metrology. The Office is also involved in defining the specifications of technical regulations and in authorising institutions to carry out market surveillance activities. In January 2004 the State Office for Standardisation and Metrology was merged with the State Institute for Intellectual Property to become the State Office for Intellectual Property, Standardisation and Metrology.

A national strategy for harmonising Croatian technical legislation with that of the EC was adopted in January 2003. This document defines the relevant responsibilities for the transposition and implementation of new approach and old approach directives.

The State Office for Intellectual Property, Standardisation and Metrology, in its capacity as *national standards institute*, has set up about 166 technical committees covering 420 CEN/CENELEC/ETSI sectors. The committees have 3100 experts representing both private and public institutions. The process of adopting European/international standards started in 1996 and so far there are 7,519 new Croatian standards, including 4,877 adopted European standards. The Croatian standardisation body has been the national representative organisation in ETSI since 1994 and has been an affiliate member of CEN and CENELEC since 1995.

The Croatian *National Accreditation Service* operates under the State Office for Intellectual Property, Standardisation and Metrology. It has accredited 22 bodies and 47 more are in the process of accreditation. The new Accreditation Act foresees the establishment of an independent accreditation body by January 2005. The present Accreditation Service is an associate member of the European Co-operation for Accreditation (EA).

There are presently about 25 private bodies providing *conformity assessment* services in Croatia in the fields of testing, certification and inspection of industrial products. The intention is to have all the conformity assessment bodies in the regulated field accredited according to international and European requirements. Under present regulations test reports by competent foreign laboratories are recognised in Croatia.

Even before the adoption of the new Metrology Act, the system of legal *metrology* in Croatia corresponded to the system in force in the EU and was based on the old approach. The present metrology system is decentralised and comprises laboratories and holders of national measurement standards. The State Office for Intellectual Property, Standardisation and Metrology is the co-ordinating institution.

Croatia has a system ensuring that products being marketed meet standard requirements. The system derives from the State Inspectorate Act of 1999, which provides for pre-market authorisation for 55 groups of products for which state inspectors issue quality certificates. The *market surveillance* structure required under the new approach still needs to be developed in accordance with the new Act on Technical Requirements for Products and Conformity Assessment. Co-ordination between the State Inspectorate and the Customs Administration as regards product conformity and safety checks at external borders is defined in the State Inspectorate Act.

In areas covered by *new approach directives*, Croatia has not yet transposed the vast majority of **sector specific legislation**. At this stage it has only adopted legislation aiming at alignment in the fields of legal metrology (non-automatic weighting equipment) and pre-packaging and equipment used in potentially explosive atmospheres (ATEX). A new Construction Act has entered into force in January 2004. Full alignment with the *acquis* on construction products is foreseen before the end of 2004. The same applies for legislation on machinery, electrical equipment (low voltage and electromagnetic compatibility), medical devices, gas appliances, pressure vessels, pressure equipment, lifts, personal protective equipment, recreational craft, toys, radio- and telecommunications terminal equipment, which Croatia is also planning to transpose by December 2004.

In sectors covered by *old approach directives*, Croatian legislation is only partially aligned with the *acquis* on motor vehicles. At this stage it remains unclear which EC type-approval certificates are accepted without rectification. Legislation on chemicals is very fragmented in Croatia and certain parts of the *acquis* are not covered. Despite the fact that Croatia is seeking to clarify the distinction between substances and preparations in a new Chemical Act, major discrepancies between Croatian and EC legislation remain. Alignment with the *acquis* on textiles and on footwear has to be continued further. As regards textiles, the Croatian Consumer Protection Act defines mandatory labelling requirements that go beyond the scope of the directive on textile names and may therefore establish barriers to the free movement of goods. The legal framework for marketing human drugs is established through the new Act on Drugs and Medicinal Products and a set of Ordinances which need to be harmonised with the *acquis*. The current technical regulation on crystal glass is largely harmonised with the *acquis*. At present there is no law in Croatia on the classification of wood.

As regards *food safety* and *foodstuffs legislation* (see also Chapter 7 - Agriculture), Croatia has only recently started preliminary alignment with the *acquis* by adopting a new Food Act in July 2003. While undertaking to incorporate the general principles and requirements laid down in the corresponding EC Regulation in the new Act, the directives on labelling, presentation and advertising and on the official control of foodstuffs have only partially been transposed. Croatia has also adopted legislation on additives, contaminants, hygiene and contacts leading to only partial alignment with the *acquis*.

In the field of food safety the Food Act provides a framework for establishing a new Food Agency. Once operational, the Agency will be given the task of analysing risks in relation to food products, deliver opinions on necessary legislation aiming to achieve EU alignment to both Ministries of Health and Agriculture and co-ordinating inspection activities between the two ministries in charge of food safety. It will be involved in training activities for various inspection bodies and the development of guides on good hygiene practice and on Hazard Analysis and Critical Control Points (HACCP). The Food Act also envisages the establishment of a central rapid alert system at the Food Agency. The Croatian system of pre-market approval for foodstuffs is not in line with the *acquis*.

On *other sectoral legislation*, Croatia's legal framework was amended in September 2003 to harmonise it with the directive on the *return of cultural objects* unlawfully removed from the territory of EU Member States. Croatia has also acceded to a number of relevant international conventions in this field. As regards civil *firearms*, a new Weapons Act has been drafted. As currently drafted, the new law would only lead to partial harmonisation with EC rules, requiring further amendments to achieve full alignment. The draft will also introduce a firearms pass which could in time evolve into the European firearms pass provided for in the relevant directive.

In the **non-harmonised area** Croatia needs to make sure that its legislation, including distinctly as well as indistinctly applicable measures, is compatible with Articles 28 - 30 EC Treaty and related jurisprudence of the European Court of Justice (with special emphasis on the principle of mutual recognition). Examples of existing measures that may be incompatible with Community law include import licences (still required for some products), advertising campaigns carried out by the Chamber of Economy, mandatory storage facilities and compulsory country of origin labelling under the Consumer Protection Act.

Croatia's legal framework broadly follows the EU rules on **public procurement**. However, several important shortcomings will have to be addressed, including the application of excessively broad exemptions still provided for under the Public Procurement Act and the scope of use of negotiated procedures. As to the remedies system, a number of issues will have to be addressed to comply with the *acquis*. In particular, tenderers prevented from responding to a call for tender due to irregularities in the procedure, should be given a chance to challenge the tender. Moreover, some implementing measures remain to be adopted.

As regards administrative structures, the Public Procurement Office (PPO) was, after a considerable delay, formally established in November 2003. The PPO is responsible for a number of key tasks relating to the implementation of the Public Procurement Act. In July 2003 Croatia adopted a new Act on the State Commission for the Supervision of Public Procurement Procedures. This Commission will deal with complaints and review procedures. Its five board members were appointed by Parliament in October 2003. Both the PPO and the State Commission now need to become fully operational and establish credible enforcement records.

Conclusion

Although in 2003 Croatia has taken first steps to harmonise its national legislation with the principle of the free movement of goods, key elements of the *acquis* are not in place yet.

In particular **horizontal and procedural measures** and **sector legislation** need to be further harmonised with EU legislation. Croatia has yet to complete the necessary separation between the regulatory, accreditation, standardisation and product certification functions, the latter two of which should be mainly left to the private sector. Significant efforts towards transposition of old approach and new approach directives will be necessary. Although initial steps have been taken to align with the *acquis*, Croatian foodstuffs legislation will have to be revised. Existing implementing structures must be improved and new implementing structures will also have to be established, in particular as regards market surveillance under the new and global approach and for certain aspects of food safety.

Provided Croatia gives early attention to the screening of its legislation, it should be able to comply with the fundamental principles of the free movement of goods that are governing the **non-harmonised area**.

In order to achieve an effective **public procurement** regime, Croatia will need to continue work in order to bring its legislative framework in line with the *acquis* and to complete the necessary implementing legislation. Despite recent progress, Croatia's capacity to implement the public procurement *acquis* still needs to be strengthened significantly.

Overall, in the field of free movement of goods, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term.

Chapter 2: Free movement of persons

The *acquis* under this chapter provides for non-discriminatory treatment of workers who are legally employed in a country other than their country of origin. This includes the possibility of cumulating or transferring social security rights, which requires administrative co-operation between Member States. In order to facilitate the practice of certain professions, the *acquis* also includes specific rules concerning mutual recognition of qualifications and diplomas; for certain professions a harmonised training curriculum must be followed to be able have the qualification automatically recognised in a EU Member State. Furthermore, this area also covers the residence and voting rights of EU citizens in any Member State.

In the area of **mutual recognition of professional qualifications**, Croatia's system is based on mandatory membership of the professional associations (chambers) as a way to regulate professions for the purpose of controlling activities and protecting the professional title. Members of professional chambers are affiliated to the social security system under the same terms as other citizens.

Existing Croatian legislation appears to provide exclusively for academic recognition. A new Act, which will come into force during 2004, provides for a procedure similar to those of the general system directives, however limited to higher education. Moreover, it does not cover the specific directives based on co-ordination of training and automatic recognition. Furthermore, the procedures foreseen in Croatia's legislation do not meet all the requirements of the *acquis*, e.g. in relation to deadlines, motivation and the right of appeal.

As regards training requirements, the Croatian system differs substantially from the EU system, namely in the health care sector. In a number of medical professions (including general practitioners and nurses), Croatian requirements do not correspond to the minimum requirements laid down in the *acquis*. In these cases the relevant titles would not be subject to automatic recognition in the EU.

In the area of **citizens' rights**, concerning *access to higher education*, there are specific requirements for foreign citizens in order to enrol if they have not been granted permanent residence in Croatia. Furthermore, the tuition fee for foreign students is different than that for Croatian students.

Croatia's legislation would have to be modified to be in line with the *acquis*. In accordance with the principle of non-discrimination on grounds of nationality laid down in Article 12 of the Treaty, Croatia should take measures to ensure that EU nationals have the right to enrol in its higher education institutions under the same conditions as nationals, without needing to be permanent residents in Croatia and without having to pay different tuition fees.

Regarding *residence rights*, in order to obtain a residence permit for longer than three months, EU citizens not exercising an economic activity need to apply for extended residence. Under certain conditions, they can also apply for permanent residence.

Croatia will need to amend its legislation in order to ensure compatibility with the *acquis* on free movement of persons, notably on the formality and conditions for entry and stay of EU citizens in Croatia.

With regard to *voting rights*, the Croatian Constitution currently restricts the right to vote to the Croatian citizens. Croatia will have to allow citizens of the Union residing in Croatia, who are not Croatian nationals, to vote and to stand as a candidate in municipal elections and in elections to the European Parliament. Furthermore, Croatia will have to enact legislation in order to transpose the relevant *acquis* on voting rights both in municipal and European parliamentary elections. The *acquis* in this area does not concern national parliamentary or presidential elections.

Concerning **free movement of workers**, the Act on Foreigners, in force since January 2004, stipulates that foreigners need a work permit. This can be given upon request from the employer within the scope of a work permit quota fixed annually by the Croatian Government. This quota should not include the work permits issued to foreign workers and members of their families, whose status is regulated by the Stabilisation and Association Agreement.

Knowledge of the Croatian language is a compulsory requirement to practise in the healthcare and pharmaceutical sector and as a notary. Under the *acquis*, mandatory requirements for language proficiency can only be applied in very exceptional circumstances, on a case-by-case basis. Care must be taken over legislative requirements on language proficiency, to ensure justified public interest, non-discrimination and proportionality.

In order to be in line with EU law on free movement of workers a series of amendments to Croatia's legislation would need to be undertaken. This includes, *inter alia*, that EU citizens would not need a work permit, and in relation to access to employment, may not be discriminated against on the basis of nationality, even if they are not yet residing in Croatia. In relation to access to the public sector only posts which are directly related to the specific activities of the public service, namely those involving the exercise of public authority and the

responsibility for safeguarding the general interest of the State, may be reserved to Croatian nationals. EU citizens must have the right to bring their family members; the spouse and children must be allowed to work without a work permit. A further series of modifications to the Croatian law would be necessary in order to ensure the freedom of movement of workers.

Furthermore, Croatia will have to adopt measures in line with the *acquis*, in particular on supplementary pension rights, in order to cover all supplementary pension schemes, compulsory or voluntary, linked to the employment activity of a person as employed or self-employed, even if, at present, such schemes do not seem to exist in Croatia.

Concerning **co-ordination of social security schemes**, the Croatian social security system includes all traditional branches of social security which come within the scope of Community co-ordination rules. Benefits and other characteristics of the Croatian system resemble those of several EU Member States. However, Croatia has a relatively high number of special benefits for war victims. The Croatian social security system is based on the principle of compulsory insurance in the country of work and contains clear definitions of employed and self-employed persons. The compulsory insurance scheme does not discriminate against non-Croatians. However, in order to have access to social security coverage, foreigners are required to have a work or business permit. Croatia has concluded a number of bilateral social security agreements with third countries, including many EU Member States. Under these agreements, Croatia already applies the principle of aggregation of insurance periods and export of benefits in relation to 23 countries. Community provisions in the field of the co-ordination of social security systems do not harmonise, but only co-ordinate Member States' social security systems. As these Regulations are directly applicable in any EU Member State, there is no need for Croatia to change its social security legislation. Only technical modifications will be necessary, in order to take account of the particularities of Croatia's social security system.

The Croatian Health Insurance Fund, the Croatian Pension Insurance Fund and the Croatian Employment Bureau would be the *administrative structures* responsible for applying the Community provisions in this field. The application of the co-ordination Regulations will have some financial implications for Croatia, in particular in the pension and healthcare area.

Conclusion

In overall terms, in the field of free movement persons, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term. In particular, these efforts should be directed to ensure full alignment with the *acquis* and adequate administrative capacity in the area of mutual recognition of professional qualifications. Due attention should also be paid to the requirements arising from the *acquis* in the field of citizens' rights (in particular on residence and voting rights and on non-discrimination in access to higher education) and of free movement of workers (namely on non-discrimination for EU migrant workers).

Chapter 3: Freedom to provide services

Under this chapter, Member States must ensure that the right of establishment and the freedom to provide services anywhere in the EU is not hampered by national legislation. In some sectors, the *acquis* prescribes harmonised rules which must be respected if the internal market is to function; this concerns mainly the financial sector (banking, insurance, investment services and securities markets) but also some specific professions (craftsmen,

traders, farmers, commercial agents). Harmonised rules concerning personal data protection and certain information society services must also be respected.

The *Stabilisation and Association Agreement* provides for the gradual liberalisation of the supply of services between the EU and Croatia.

As regards the **right of establishment**, the Croatian regulatory framework needs to be adapted so as to ensure that remaining barriers for natural and legal persons from the EU are abolished. For example, Croatian securities legislation requires any company established in Croatia that has more than 100 shareholders and a share capital greater than 30 million HRK (€4m) to be listed on a stock exchange. This requirement constitutes a barrier to establishment by EU operators.

As regards the directly applicable provisions of the EC Treaty concerning the **freedom to provide services**, Croatia will need to remove barriers to the provision of cross-border services by EU companies. Croatian law does not distinguish between operators established in an EU Member State providing services on the territory of Croatia on a temporary basis and those providing services through a permanent establishment. EU service providers currently cannot pursue a business activity in Croatia without establishing a branch or a subsidiary there. Moreover, Croatia's legislation contains a number of requirements which may constitute barriers to the provision of services on an occasional or temporary basis, e.g. the need to provide certified translations of documents, the need to obtain a licence to exercise a craft, and the need for both a "manager" and an "authorised representative".

As regards **financial services**, there has been a gradual consolidation of the Croatian **banking sector** and a steady increase in the number of subsidiaries of EU credit institutions. The main piece of legislation governing the banking sector is the Banking Act, which provides a good basis for harmonisation but does not cover all aspects of the relevant EU *acquis*. The Act stipulates that after Croatia's accession to the EU, banks that are authorised to provide banking and other financial services in an EU Member State may also provide these services, through a branch or directly, in Croatia. Other legislation establishes accounting rules for credit institutions and Croatia operates a deposit guarantee scheme. New rules on the capital adequacy of banks and investment companies entered into force in January 2004. There is no specific legislation on conglomerates, e-money institutions (only banks are entitled to issue e-money) and winding-up of credit institutions. Apart from this, divergences between Croatian law and the *acquis* for the banking sector appear to be mainly of a technical nature, covering issues such as co-operation between supervisory authorities, exchange of information between Croatian competent authorities, minimum capital requirements and the adaptation or the introduction of some legal definitions in Croatia's national law.

The National Bank is the competent authority for granting operating licences and supervising credit institutions. Its powers are set out in the Croatian National Bank Act and the Banking Act. The Banking Supervision Department of the Croatian National Bank conducts banking supervision and employs 75 staff. There is a programme of continuous professional training. The National Bank's supervisory powers appear to be broadly in line with international standards according to the IMF's assessment carried out in mid-2002.

Savings and loans co-operatives are licensed and supervised by the Division for Financial Institutions Supervision of the Ministry of Finance pursuant to the Savings and Loans Co-operatives Act. Should these co-operatives be covered by the definition of credit institutions provided by the banking directives, this may raise a problem in relation to the independence and competences of the supervisor.

The **insurance market** in Croatia is highly concentrated. It is dominated by non-life insurance with about 80% of gross written premium; the largest class by far is Motor Third Party Liability (around 1/3 of premium income). The share of foreign controlled companies in the domestic insurance market does not exceed 25%, although their share of life insurance is above 50%. The main legislation governing the insurance system is the Insurance Act and the Act on Mediation and Representation in Insurance. The Insurance Act is partially harmonised with the EU directives regulating life insurance, non-life insurance and vehicle insurance. However, a significant amount of further work will be necessary to achieve full alignment with the *acquis*.

As regards *administrative structures*, the basic supervisory function is in place but, as highlighted by the IMF in mid-2002, the organisation and resources available to the supervisory authority need to be strengthened in order to allow it to effectively discharge its functions. The Directorate for Supervision of Insurance Companies and the Croatian Insurance Bureau have been established on the basis of the Insurance Act. The Directorate, which currently employs approximately 15 staff (although no actuaries are employed), carries out supervision in order to protect the interests of policyholders. It issues approvals for operation and approves the business acts and the appointment of management boards. It also prescribes the standards for the financial operation of the companies and establishes the types of insurance and risk groups. The functioning of the Directorate has so far not been satisfactory and a reorganisation is envisaged. The Croatian Insurance Bureau represents insurance companies in international institutions, protects traffic casualties and deals with damage in foreign states. The bureau also manages the guarantee fund for payment of certain damages in the field of mandatory insurance. The Bureau appears to function in a satisfactory manner.

The **securities markets** in Croatia are still underdeveloped. Although two stock exchanges exist, the capital markets are neither deep nor liquid and the stock-market capitalisation was equivalent to about 30% of GDP at the end of 2002. Croatia's legislative framework regulating securities markets and collective investment undertakings provides a basis for the necessary alignment with the *acquis*. The main legal acts are the Securities Market Act and the Investment Funds Act. However, an investment compensation scheme has not yet been created.

As regards *administrative structures*, the Croatian Securities Commission (CROSEC) was established in 1996 and became operational towards the end of 2002, with the nomination of all its members and the adoption of its Statute by the Croatian government. CROSEC has 27 employees. In August 2002, the IMF found that there was a need to strengthen the powers of the CROSEC and to clarify its procedures. Although some progress has been made since then, additional efforts should be made to strengthen its supervisory capacity.

As regards supervision of financial conglomerates, co-operation among Croatian supervisory authorities has not been formalised yet. However, a Programme for Supervision of Financial Institutions and the Financial Market on a Consolidated Basis has been adopted by the Parliament. On this basis, the creation of a co-ordinating board with representatives of the sectoral supervisory institutions is planned.

An Act on **Personal Data Protection** and the free movement of such data was adopted in 2003 and seems to be broadly in line with the main provisions of the *acquis*. The legislation includes "adequate level of protection" requirements for transfers of personal data to third countries, but does not provide for the derogations foreseen in the directive on personal data

protection. The creation of a Personal Data Protection Agency, whose head is to be appointed by Parliament, is foreseen but it has not yet been established.

Regarding **information society services**, Croatia has adopted the Electronic Commerce Act, which partially transposes the *acquis*. Croatia will have to ensure adequate means of supervision in this area and appoint a contact point to co-operate with authorities in other EU Member States. It should also take steps to prohibit the production, manufacturing, sale and distribution of pirate smart cards and other devices circumventing the encryption of conditional access services, as well as to ensure adequate sanctions.

Conclusion

In general, barriers to establishment or provision of cross-border services by natural or legal persons from the EU need to be abolished.

Croatia has made considerable efforts towards approximation of its legal and supervisory framework with EU standards in the field of financial services. In this regard, the banking sector appears quite advanced, although further improvements are necessary. The legal and supervisory framework for the insurance market and for investment services and securities markets needs further development and alignment with the *acquis*.

Overall, Croatia will have to make considerable further efforts to strengthen the legal and supervisory framework, including for financial services, in order to align its legislation with the *acquis* and to effectively implement and enforce it in this area in the medium term.

Chapter 4: Free movement of capital

Member States must remove all restrictions in national law on the movement of capital between themselves, but also with third countries (with some exceptions) and adopt EU rules to guarantee the proper functioning of cross-border payments and transfers of all forms of capital. The *acquis* also includes harmonised rules on payment systems. The money laundering directives establish money laundering as a criminal offence. They require financial institutions to identify and know their customers, to keep appropriate records and to report any suspicions of money laundering. The directives also embrace the activities of auditors, external accountants, notaries and lawyers, casinos, real estate agents and certain dealers in high-value items for large cash transactions. Adequate enforcement capacity is required.

The *Stabilisation and Association Agreement* sets out a timetable for capital liberalisation in the years following its ratification. It also provides for progressive liberalisation of the real estate market.

With regards to **capital movements and payments**, Croatia became an IMF member in 1992 and introduced full current account convertibility in 1995. Over the period 1998-2001, foreign direct investment amounted to more than €5 billion, of which 55% came from the EU. In recent years, Croatian residents have also begun to invest abroad. Approximately 90% of the banking system (in terms of assets) is in foreign ownership.

The Foreign Exchange Act, in force since June 2003, aligns definitions with the *acquis* and provides the framework for progressive capital liberalisation. Direct investment by non-residents in Croatia is unrestricted, unless otherwise provided by special laws. Such sector specific laws reflect either a public interest (e.g. narcotics, pluralism of the media), the exercise of public authority (e.g. public notaries), or sectors currently governed by bilateral

agreements (e.g. transport and fishing) and need to be brought in line before accession. Inward investment by non-residents and foreign citizens in real estate is subject to restrictions and is also hampered by the serious weakness of Croatia's land registration system.

Alignment with the *acquis* will also be required in the areas of investment rules for institutional investors (e.g. pension funds and savings and loan cooperatives), special rights of the government in privatised enterprises (telecoms, oil and electricity companies), as well as specific requirements regulating external exposure of the financial system and the elimination of remaining restrictions on short-term capital movements.

As regards **payment systems**, the Croatian legal framework concerning cross-border transfers is based on the Foreign Exchange Act and needs to be brought further into line with the *acquis*. For example, financial institutions should have an obligation to inform their customers about the conditions for cross-border credit transfers and a special compensation should be introduced in case of failure to execute a transfer. In addition, the redress scheme foreseen (arbitration and conciliation before the Permanent Arbitration Court and the Conciliation Centre at the Croatian Chamber of Commerce) appears to be an excessively heavy procedure.

Croatia has built up an anti-**money laundering** framework in recent years. It participates in the work of the Council of Europe's Select Committee of Experts on the evaluation of anti-money laundering measures (Moneyval), which acts as the regional Financial Action Task Force (FATF)-styled body. In July 2003, Moneyval adopted the second evaluation report on Croatia. Alignment with the recommendations of the report will be of critical importance.

The Penal Code criminalises money laundering, following an all crimes approach and including gross negligence, corporate criminal liability and self laundering. However, the money laundering offence is based on actual knowledge that the money or property was acquired by a crime. The Law on the Prevention of Money Laundering of 1997 has recently been revised and the amendments entered into force in January 2004. The Law includes obligations to identify customers, to report suspicions of money laundering and cash transactions above a threshold to the Office for the Prevention of Money Laundering (OPML, the Croatian financial intelligence unit within the Ministry of Finance), and to keep records. The list of entities subject to anti-money laundering measures is comprehensive.

The legislation needs to be further aligned with the second EU Money Laundering Directive. For example, the obligation to identify/verify customers has certain shortcomings such as the position of non-permanent business relations and one-off transactions, the identification of persons operating on behalf of legal persons as well as the exemption on withdrawals from savings accounts. Moreover, supervisors also need to be obliged to report suspicions of money laundering. The OPML may request additional information further to suspicious transaction reports, but it is unclear why reporting institutions are allowed to object to such requests. Penalties are of an administrative nature and appear to be rather low.

Numbered accounts and bearer pass books are allowed for residents, but customer identification is required. The new Securities Law no longer allows bearer shares.

As regards administrative capacity, the effectiveness of the system, including the resources of the OPML, needs to be strengthened. Feedback is only provided to banks. Internal procedures, training of employees and awareness of money laundering among reporting institutions, supervisors and law enforcement agencies need to be improved, including by creating a legal basis where appropriate. Moreover, supervision of compliance with anti-money laundering legislation in the banking and non-banking sectors and guidance to these sectors should be

strengthened in terms of adequacy of the mandates, powers, means, co-operation with other bodies and actual compliance with the legislation. In view of the deficiencies of the system, results in terms of convictions and confiscations have so far been limited. (*See also Chapter 24 – Co-operation in the field of Justice and Home Affairs*).

Conclusion

Overall, Croatia will have to make further efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the area of capital movements, payments and payment systems in the medium term. Croatia needs to complete the establishment of its anti-money laundering system. If sufficient resources are provided to implement the law and if known weaknesses in the system are addressed, it should be possible to develop an effective anti-money laundering system in the medium term.

Chapter 5: Company law

Under this chapter, Member States must adopt and apply harmonized rules required for the proper operation of companies in the internal market. They concern five legislative fields: company law in the strict sense, accounting law, intellectual property rights, industrial property rights, and the recognition and enforcement of judgments in civil and commercial matters as well as of contractual obligations.

The *Stabilisation and Association Agreement / Interim Agreement on trade and trade-related matters* contain the obligation for Croatia to guarantee no later than three years after the entry into force of the Interim Agreement (i.e. by March 2005) a level of protection of intellectual, industrial and commercial property rights similar to that existing in the Community, including effective means of enforcing such rights. This obligation covers *inter alia* copyright, including the copyright in computer programmes, and neighbouring rights, the rights related to databases, patents (including Supplementary Protection Certificates), industrial designs, trademarks and service marks, topographies of integrated circuits, geographical indications, including appellations of origins, as well as protection against unfair competition as referred to in Article 10a of the Paris Convention for the Protection of Industrial Property and the protection of undisclosed information on know-how.

Croatia's *legal framework* in the field of **company law** was established with the Companies Act of 1993 and has recently undergone extensive amendments, which entered into force in January 2004. Minimum capital requirements are laid down by law and there are safeguard clauses for the protection of authorized capital. Various obligations exist for the protection of creditors and the right of information is one of the fundamental shareholders' rights; companies are required to publicize information about major decisions affecting them. In general this legal framework provides a good basis for further alignment to the company law *acquis*. An act regulating the procedures for the takeover of public limited liability companies is in place since 2002.

Concerning *administrative structures*, information on companies is held in the Commercial Court Registers. Financial statements are kept separately in the Financial Agency registers. It is not clear to what extent these two registers are linked. Commercial courts publish company information in the Official Gazette and in one daily newspaper. The registers are publicly accessible and consultation fees are limited to covering costs. The time required to register a company varies from one Commercial Court to another and is reported to range from a few days up to three weeks (additional delays for business start-ups are associated with

registration at customs, tax and statistics administrations, which may take up to four months; *See also Chapter 16 – Small and Medium-sized Enterprises*).

The **accounting field** is regulated by the Accounting Act of 1992. The Croatian Accounting Standards Board is the standard setting body. The law provides for sanctions for non-compliance with financial reporting requirements. A new Accounting Act is in parliamentary procedure and will establish a Financial Reporting Council with rule-making powers. Croatia has already taken steps for the transition to International Accounting Standards (IAS) based accounting. However, further attention should be given to proper compliance with IAS and their enforcement.

On **auditing**, an Audit Act exists and stipulates that the Ministry of Finance issues licenses to audit companies. The Croatian Government has adopted a plan to comply with all *acquis* requirements in this field.

In the field of **intellectual and industrial property rights**, Croatia is a party to the WTO TRIPs Agreement and to the main international conventions in this area, including the WIPO Copyright Treaty (WCT) and the WIPO Performances and Phonograms Treaty (WPPT). Croatian legislation provides for a specific border regime in relation to intellectual and industrial property rights. However, effective enforcement, including the fight against piracy and counterfeiting, remains a key challenge for Croatia. Particular attention should be given to providing law enforcement with sufficient resources and expertise and to improving the effectiveness of the judiciary. As regards *administrative structures*, the former State Intellectual Property Office (SIPO) had a staff of 88 employees and seems to be seriously understaffed in some sectors which need rapid strengthening. In January 2004 SIPO was merged with the former State Institute for Standardisation and Metrology to become the State Office for Intellectual Property, Standardisation and Metrology.

The Croatian *legal framework* on **intellectual property rights** underwent comprehensive reform in 2003 with the adoption of the new Act on Copyright and Related Rights. This law constitutes a comprehensive legal text covering the scope of protection, including rights and exceptions, provisions on the protection of technological measures, copyright contract law, collecting societies as well as enforcement of rights and the artist's resale right. It brings Croatian legislation in the field of copyright and related rights largely in line with the *acquis* but some amendments will be necessary to achieve full alignment. The necessary legal instruments to fight piracy and counterfeiting are in place but due attention must be paid to proper enforcement. Concerning *administrative structures*, SIPO's copyright department had only one staff member in mid-2003 and needs to be reinforced.

Also with regard to **industrial property rights**, the Croatian *legal framework* was subject to a comprehensive review in 2003 with the adoption of a new Patent Act, a new Act on Industrial Design, a new Trademark Act, a new Act on Geographical Indications and Designations of Origin of Products and Services and a new Act on the Protection of Topographies of Semiconductor Products. In addition, the European Patent Organisation and Croatia have recently signed an extension agreement concerning applications for European patents. Further to this agreement European patents can be extended to Croatia provided that, at the time of filing, an extension is duly requested. While Croatian legislation appears to be broadly in line with the *acquis*, additional amendments will be necessary to reach full compliance. As regards *administrative structures*, the staffing of the technical experts section of the patent Department of SIPO should be strengthened and a training program should be established as a matter of priority. There is an important and growing backlog in the processing of patent applications due to complex and lengthy procedures, which should be simplified.

Conclusion

Concerning company law and accounting, Croatia has made efforts towards approximation which need to be pursued. The full transparency of company registers should be ensured and the sometimes lengthy registration procedures reduced. In addition, enforcement of accounting and audit standards would need to be strengthened.

In the field of intellectual and industrial property rights, Croatia has taken important legislative measures during 2003. Further work will be necessary to reach compliance with the *acquis*. Croatia must also pay due attention to respecting the deadline set in the Interim Agreement. Furthermore, implementation procedures and the relevant administrative structures need to be strengthened in order to ensure effective enforcement of legislation. Particular attention must also be devoted to the fight against piracy and counterfeiting, in particular via adequately resourced law enforcement bodies and an effective judiciary.

Croatia has taken several important steps towards aligning its legislative framework with the *acquis* but legislative alignment needs to continue and administrative capacities in the field of intellectual and industrial property rights need to be strengthened. Overall, in the field of company law, Croatia will have to make further efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term.

Chapter 6: Competition policy

The competition *acquis* covers both anti-trust and State aid control policies. It includes rules and procedures to fight anti-competitive behaviour by companies (restrictive agreements between undertakings and abuse of dominant position), and to prevent governments from granting state aid which distorts competition in the Internal Market. Generally, the competition rules are directly applicable in the whole Union, and Member States must fully cooperate with the Commission on the enforcement of these rules.

The *Stabilisation and Association Agreement / Interim Agreement on trade and trade-related matters* provides for a competition regime to be applied in trade relations between the Community and Croatia based on the criteria of Articles 81 and 82 of the EC Treaty (agreements between undertakings, abuses of dominant position), Article 86 (public undertakings and undertakings with special or exclusive rights) and of Article 87 (State aid). It also provides that an operationally independent public body must be entrusted with the powers necessary for the full application of this competition regime. Furthermore, the Interim Agreement stipulates specific State aid disciplines for the steel sector, including the obligation for Croatia to present a restructuring and conversion programme for its steel industry to the Commission.

In the **antitrust sector**, the *legislative framework* in Croatia is provided by the Competition Act adopted in June 2003 and in force since October 2003. It replaced a previous law from 1995 and contains the main principles of the Community anti trust rules. In particular, the legislation encompasses the prohibition of restrictive agreements, as well as the abuse of dominant position. However, certain aspects of the Croatian Competition Act, such as the procedure for the automatic nullity of restrictive agreements, still need further amendment to become fully in line with the *acquis*. Also the conditions for granting exemptions from the prohibition of restrictive agreements need to be fully brought in line with the cumulative conditions of Article 81 EC Treaty. Furthermore, the Croatian General Administrative Procedure Law potentially interferes with the Croatian Competition Act. In order to ensure

the full independence of the Agency for the Protection of Market Competition, the possibility to issue an extraordinary annulment decision on the basis of the Croatian General Administrative Act against the decision of the Agency for the Protection of Market Competition needs to be excluded.

As regards *administrative capacity*, the Agency for Protection of Market Competition (APMC) is in charge of implementing the Croatian competition law. The Agency was established in 1995. According to the Competition Act, the Agency acts as an independent entity autonomously performing its activities. In September and October 2003 the president and the other four members of the Committee for Market Competition, the management and decision-making body of the Agency, were appointed. The Agency currently employs 28 people, including the five members of the Committee. It still remains to be seen to what level the administrative capacity of the APMC is already developed in reality.

Given the recent entry into force of the legal framework, there is not yet sufficient information on the *enforcement record* of the Agency. In the near future, the most important challenge for the Agency is to ensure the effective application and enforcement of the anti-trust rules in relation to undertakings so that they become sufficiently accustomed to a competition environment similar to that of the Community well before full membership. This also requires a well-functioning judicial system that can effectively deal with appeal procedures against decisions of the Agency and render decisions in conformity with the Community *acquis*. Moreover, public administration and the relevant economic operators will need to have a sufficient understanding of competition law and policy.

In the field of **State aid**, prior to 2003 no comprehensive legal framework existed in Croatia. In 2003 Croatia took important steps for creating such a framework by adopting the State Aid Act and the Regulation on State Aid, which respectively entered into force in April and July 2003. However, it remains to be seen whether, in practice, this framework provides sufficient powers for the controlling authority to ensure a full and proper control of all new and existing aid schemes in line with the Community *acquis*.

In order to fully comply with the EU *acquis* in the State aid field, the Agency for the Protection of Market Competition, as State aid controlling body, must be entitled to authorize general aid schemes and not only to give an opinion. Certain additional amendments to the Croatian State aid law will be necessary. Amongst those, one urgent amendment is related to Article 4 (3) d) of the Croatian State Aid Act according to which State aid to facilitate the development of certain economic activities or of certain economic areas may be considered compatible. This provision should be applied only in very specific (rather exceptional) circumstances. More generally, the awareness of aid schemes going beyond direct budgetary support, particularly as fiscal aid is concerned, appears to be low in Croatia. In this context the compatibility of the Act on Areas of Special State Concern, the Free Zones Act and the Investment Promotion Act with the *acquis* remains to be determined.

Concerning *administrative capacity*, in addition to the competence for anti-trust, the Agency for the Protection of Market Competition has also been made responsible for the implementation of the State Aid Act and for the drafting of the necessary by-laws. It will need the necessary additional administrative resources to this effect. Procedural rules have to be in place to enable the national state aid monitoring authority to receive notifications of all proposed aid projects from the aid granting bodies and to obtain from them all necessary information as well as to express its opinion prior to the grant of the proposed aid (standstill clause).

The challenge for the Agency will be to establish rapidly a credible *enforcement* record as the authority controlling State aid. At this stage the legal framework and the administrative structure are too recent to draw conclusions on this. Reliable data on the use of state aid in the Croatian economy is very limited and transparency is low. No reliable state aid inventory exists at present. Under Article 35 of the Interim Agreement Croatia is obliged to provide the Commission with a comprehensive State Aid inventory as well as with a regular annual report on state aid. The State aid inventory is crucial and the Agency for the Protection of Market Competition must ensure early on that all relevant measures are covered and that these measures have been assessed so as to establish their compatibility under Article 87 of the EC Treaty.

As regards **public undertakings and undertakings with special or exclusive rights** entrusted with the operation of public services, the Croatian Competition Act is fully applicable to them, in accordance with Article 86 of the EC Treaty.

As regards undertakings entrusted with the operation of services of general economic interest, the Croatian Competition Act has taken over the wording of Article 86 (2) of the EC Treaty except for the proportionality test. That allows too broad a scope of action for undertakings operating services of general interest. Therefore, in the absence of any limitation there is a risk that such undertakings may fully back out of the scope of the Competition Act.

Finally, with regard to the liberalisation of specific sectors, it remains to be seen how sector specific legislation will impact on the effective application of the general competition rules in the sectors covered (telecommunications, banking, energy, petroleum and petroleum products, gas). The liberalisation of specific sectors of the economy is dealt with in the relevant sector specific chapters.

Conclusion

In the field of anti-trust, the basic legislative framework is now in place. The approximation process with the *acquis* must continue and the Agency for the Protection of Market Competition needs to be strengthened. In parallel, the Agency will have to build up a credible enforcement record.

Regarding State-aid, important steps towards creating the necessary legal framework have been taken in 2003 but it needs to be completed. Croatia will have to increase transparency and awareness of State-aid rules and to ensure an effective control of State aids, in particular by giving the Agency all the necessary powers. Developing the appropriate administrative capacity of the Agency for the Protection of Market Competition will be crucial.

Overall, in the field of competition, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term.

Chapter 7: Agriculture

The agricultural chapter covers a large number of binding rules, many of which are directly applicable. The proper application of these rules and their effective enforcement by an efficient public administration are essential for the functioning of the Common Agricultural Policy. This includes the setting up of management systems such as a Paying Agency and the Integrated Administration and Control System, and also the capacity to implement rural

development actions. EU membership requires integration into the common market organisations for a range of agricultural products, including arable crops, sugar, animal products and specialised crops. Finally, this chapter covers detailed rules in the veterinary field, which are essential for safeguarding animal health and food safety in the internal market, as well as in the phytosanitary field, including issues such as quality of seed, plant protection material and harmful organisms.

The *Stabilisation and Association Agreement / Interim Agreement* regulate preferential trade of agricultural products.

Croatia is in the process of creating the necessary conditions for its agriculture to face EU competitiveness and develop adequate working and living conditions in rural areas. Croatia has experienced the different phases of agricultural adjustment faced by other countries of Central and Eastern Europe. After a dramatic initial decline of agricultural production in the first half of the 1990s, agricultural production stabilised mainly in the area of crop production. Wheat and maize cover 57% of the arable area in Croatia. Similarly to other transition economies, Croatia has also experienced a rapid and ongoing decline of livestock production in general and in particular of cattle production. This has been caused by weak and shrinking markets, low competitiveness of the farms and the processing sector and little access to capital. Despite a declining trend, the economic importance of agriculture is still relatively high, as its gross value contributes around 10% to total GDP. Croatia's agriculture is dominated by family farms. The average size of farms is 2.8 ha, while about 84.5% of crop area and 94.3% of cows are kept in private farms. About 47.5% of rural households farm less than 1 ha and about 39.4% farm 1 to 5 ha of agricultural area. Subsistence and semi-subsistence agriculture are very important features for Croatia's agriculture and for the rural economies. Efforts of increasing the competitiveness of the agri-food sector in Croatia, therefore, depend predominantly on the revival of rural economies rather than on market-oriented agricultural policies.

The changing structure of agricultural production is reflected in the **agricultural trade**. Overall agri-food exports were €487 million in 2002, which represents a 31% increase from 1995. Over the same period total agri-food imports increased by 37%, reaching €963 million in 2002. Nevertheless, the share of agriculture in total trade has decreased throughout the period 1995-2002, from 10.5% to 9.4% concerning exports and from 12.3% to 8.5% concerning imports. Croatia continues to be a net importer of agricultural products. Trade with the EU-25 in 2002 amounted to €213 million for exports and €725 million for imports. The trade balance with EU-25 follows the general trend of growing deficit, amounting to a negative balance of 512 million in 2002. The main agricultural and agro-food products exported by Croatia were tobacco and tobacco products, miscellaneous food preparations, sugar and sugar confectionery and cereals. The main agricultural and agro-food products imported by Croatia were miscellaneous food preparations, beverages, fruits and nuts, live animals and dairy products. Croatia became a member of the WTO in 2000 and has committed itself to a phased reduction of barriers to agricultural trade over the period to 2005. Free trade agreements exist with most European countries.

The main **legislative framework** in this area comprises the Agriculture Act, the Agricultural Land Act, the Act on the Ecological Production of Agricultural and Food Products, and the Act on State Aid in Agriculture, Forestry and Fisheries. Several Government Ordinances regulate specific sectors. The Government operates within the framework of a National Programme for Agriculture and Rural Areas and of an Agriculture and Fisheries Development Strategy adopted by the Parliament.

Concerning **horizontal issues**, preparations for a *Paying Agency* and *Integrated Administration and Control System* (IACS) are at a very early stage, though Croatia aims to develop them on the basis of existing structures, that is the Directorate for Market and Structural Aids within the Ministry of Agriculture and of a farm register linked to a central computerised database. Since the *acquis* on Paying Agency and IACS, which are central elements for payment of Common Agricultural Policy funds to farmers, is very demanding, planning and preparation will require extensive investment and institution-building well in advance of accession. Croatia's trade mechanisms are limited to the management of import quotas and import/export licenses, whilst no export subsidies are in place. Apart from the basic provisions of the Food Act, no specific measures in line with EU legislation are in force concerning organic farming and quality policy. Croatia will also need a Farm Accountancy Data Network (FADN) in line with the *acquis*, since agricultural bookkeeping systems presently are considered only as one of the measures for the general development of rural areas.

With regard to *State aids* other than market-related subsidies and rural development measures, Croatia has set up other systems to grant aids to farmers, namely: an exemption from the excise duty on Eurodiesel for producers of cereals, oil crops, sugar beet and tobacco; the application of 0% VAT rate for all types of bread and milk; a financial aid for insurance of crops against damages; and a compensatory aid for mitigating damages caused by natural disasters. Croatia grants subsidies for production of lavender and medicinal herbs and for establishing new lavender plantations. Croatia will need to bring all its State aids measures in line with the Treaty provisions and the guidelines adopted in this area.

Arable crops. Concerning *arable crops* production, Croatia grants production subsidies for cereal crops (wheat, rye, triticale and fodder cereals), oilseeds (sunflower, soybeans and rape seed) but not for protein crops. Subsidies are different for bread-making quality and fodder cereals. Management and control of this scheme diverges from the EU system. The procedures inherited from the former subsidies management system are currently being harmonised and preparations are being made for alignment with IACS (Integrated Administration and Control System). Also, the agricultural inspection body is currently being restructured. The Croatian intervention system needs to introduce minimum quality standards for internal quality requirements (such as protein content, Zeleny, Hagberg). Croatia should also adapt administration of the import and export regime in this sector, in particular introducing import/export licenses and export refunds. With regard to *sugar*, Croatia grants area-based subsidies for the production of sugar beet, above a minimum threshold, which are not compatible with the *acquis*, and applies custom duties and preferential quotas. No mechanism is in place, which would correspond to the key management instruments of the sugar common market organisation (production control measures, inter-professional agreements, intervention price system and communication system). Continued attention must be paid to proper control of the proof of origin for exported sugar. Basic national administrative structures are in place, which might serve as a basis for setting up the necessary instruments, but these would need to be significantly strengthened to manage the common market organisation for sugar.

Animal products. In the *milk and dairy* sector Croatia grants an aid per litre of milk above a minimum threshold, based on a 3.7% fat content level. The subsidy is higher for less favoured areas. Similarly to the EU system, Croatia has production subsidies, target price for milk, duties and preferential tariff quotas. However, no intervention system and no quota management measures are currently in place or planned. Croatia's milk production is equivalent to only 80% of its annual consumption of milk and dairy products, and the difference is covered by imports. Concerning *beef* and veal, Croatia has specific schemes for

cattle fattening, cattle rearing and dairy cows. Trade measures are also applied. In order to be fully compliant with the *acquis* in this area, Croatia should start preparations for an animal identification system, beef carcass classification and a proper price reporting system. Production subsidies above a minimum threshold are also granted to raise *sheep and goats*. The subsidy is higher for less favoured areas. Unlike in the EU system, male animals are also eligible for payment. No intervention and private storage measures are applied. Croatia should establish adequate carcass classification and develop a price reporting system based on carcass weight. In the *pig meat* sector, per head subsidies are granted for fattening and raising pigs above a minimum threshold, which is not in line with the EU legislation. Customs duties and preferential quotas are applied. The EUROP carcass classification method seems to be in place, but not yet linked to a functional price reporting system. Adequate arrangements would also be required to manage the EU schemes for private storage and export refunds. Concerning *eggs and poultry*, Croatia grants production subsidies above a minimum threshold, besides applying customs duties and preferential quotas. Marketing standards and price reporting in line with EU provisions are not yet applied and should be developed in view of accession. The Croatian Livestock Centre is responsible for a number of functions in the animal products sector.

Specialised crops. In the area of *fruit and vegetables*, Croatia applies a yearly hectare-based production subsidy and one-time payments for planting new orchards. These measures are not in line with the *acquis*. No subsidies are granted for processing fruit and vegetables. Development of producer organisations is at a very early stage and should be further encouraged. Particular attention should be paid to aligning Croatian marketing standards to the EU standards and setting up a quality inspection body. An adequate market information system should also be put in place. In the wine sector, Croatia grants per-hectare subsidies for grape production and planting of new vineyards, and one-time subsidies for grapevine planting material. These measures are not in line with the *acquis*. No restrictions are in place on planting grapevines in Croatia and no distillation measures are applied. No intervention measures are applied in the area of wine production. Subsidies for *olive oil* are in place for the production of olives, the planting of olive groves, for planting material and for the production of virgin olive oil. Only the subsidy for the production of olives would be compatible with the EU provisions. Croatia should develop a computer-based Geographical Information System (GIS) in line with the *acquis*. Furthermore, Croatia will need to align its legislation on marketing standards and on the technical characteristics of olive oil and the relevant methods of analysis. Concerning *fibres*, Croatia applies customs duties for flax and hemp. It does not appear to comply with other provisions of the *acquis* in this area, in particular the specific conditions applying for imports of hemp into the EU. For the *bananas* sector, Croatia operates a tariff-only system with a current ‘most favoured nation’ tariff of 10%. The tariff-only system is in line with the system applicable in the EU from 2006, but Croatia will also need to adopt the EU quality standards. Production subsidies are given to *tobacco* growers. A system of guaranteed price is also in place, unlike in the EU. For *seeds* Croatia grants a subsidy based partly on production and partly on area. The latter is not in line with the current *acquis*. The scope of the seed varieties eligible for aid is also wider than in the EU. A production aid is also granted for *hops*, coupled with subsidies for establishing new plantations and for certified plant materials. Croatia aims at increasing production in this area, whereas the EU is trying to adapt production to market demand.

Concerning **rural development**, within the Agriculture and Fisheries Development Strategy the Rural Development Model includes three main programmes: for rural areas development, for conservation of indigenous and protected breeds, and for agricultural products marketing preparations. These documents show Croatia’s commitment to rural development both at

national and regional level, with policy objectives similar to those of the EU. The activities currently carried out indicate that a capacity to develop and implement rural development policy already exists, together with financial allocations from the national budget. A national definition of less favoured areas is already in force. These preparations will provide a good starting point for the future development of rural development programmes in line with the *acquis*. However, thorough preparations will be required to adopt EU-compatible delivery mechanisms, in particular paying agencies. Co-operation between all services involved should also be strengthened.

In the veterinary and phytosanitary sectors, Croatia has in general functioning veterinary and phytosanitary services under the responsibility of the Ministry of Agriculture.

In the **veterinary field**, the main legislative provisions are the Veterinary Medicine Act, the Act on Veterinary Medication and Veterinary-Medical Products and the Animal Welfare Act. Several Government Ordinances regulate specific issues in this area. Croatia already applies some principals of the EU legislation. A number of basic directives have been partially transposed, but remain to be brought fully in compliance with the *acquis*. Although efforts have been noted in the handling of *transmissible spongiform encephalopathies* (TSE) and *animal by-products*, Croatia has to prove its capacities to strictly align its legislation with the *acquis* (in particular compliance of TSE-related import restrictions with the *acquis* and culling policy in case of outbreaks) and implement and control its enforcement. Croatia's far-reaching TSE-related import restrictions affecting all but three Member States are not based on scientific justifications and thus constitute a violation of the Interim Agreement. Croatia should therefore bring its import regime for live animals and meat products in line with its international sanitary and phytosanitary (SPS) obligations and with the EU *acquis*.

A system for *identification and registration of animals* is currently being set-up and should be brought into compliance with EU norms. Basic *animal disease and animal health control systems* exist but need to further aligned to the EU legislative and institutional requirements. The basic principles of the EU legislation on *animal welfare* are introduced in the national legislation. Croatia will have to put efforts in the field of *common measures*, since important elements of the *acquis* are not yet transposed. Residue monitoring capacities will need to be upgraded.

With regard to *public health in agro-food establishments*, only a few sites satisfy EU structural and hygiene requirements and are currently listed for exporting to the EU. A large number of establishments will need important investments to upgrade their facilities and should be supported in this task. The legislation and provisions with regard to *animal nutrition* need to be fully revised. The Croatian authorities need to make significant efforts to bring the management of the *national regime of veterinary checks*, the regime of *veterinary checks of imports from third countries*, and *import rules* into line with EU requirements, in particular concerning training of inspectors and adequate laboratory equipment.

In the **phytosanitary** sector, legislation has been partially brought in line with the *acquis*. The main legislative provisions are the Plant Protection Act and three Ordinances: on phytosanitary inspection of plant and control of plant protection on products in the national cross-boundary transportation; on mandatory plant health check of crops and facilities, seeds and planting material; and on terms and conditions of entry of agricultural and horticultural seeds and agricultural propagating material into national catalogues of varieties. In the field of *harmful organisms*, Croatia has to introduce the concept of protected zones in its legislation, without having the obligation to establish protected zones within its own territory, and to continue work on the EU control directives. The issue of *plant protection products* needs

further attention and the reform of the related administration should comply with the *acquis*. Residue monitoring capacities need to be further developed. Important EU directives in the field of *seeds and propagating material* will need to be transposed. As regards *plant varieties*, Croatia has started to transpose the aspects related to marketing and protection.

Croatia has to ensure that the international veterinary and phytosanitary agreements that are currently in force are brought into compliance with the *acquis*.

In the field of food safety, a Food Act was adopted in 2003, partially implementing the *acquis* in this area. The Act provides for the future establishment of a Food Agency, which, once established, should manage risk assessment, co-ordination of inspection activities between the Ministries involved, and should manage the central rapid alert system (*see Chapter 1 – Free movement of goods*).

Conclusion

In the field of agriculture, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term.

Several measures currently in force in the Croatian agricultural policy are not in line with the *acquis* and should be gradually phased out. Croatia will need to start timely preparations to set up the basic instruments for managing the Common Agricultural Policy, in particular an EU-compliant paying agency and an IACS system. Due attention should be paid to strengthen administrative capacity to manage common market organisations and rural development activities.

Croatia has made an effort to align with the EU standards in the veterinary and phytosanitary sectors. The Croatian authorities must make significant efforts to reorganise their administrative structure and management so as to enable EU compatible control system to be put in place, particularly regarding the system of import controls. However, important gaps remain and significant efforts are required from Croatia to consolidate the recent reforms and modernisation of the legal framework and to further adapt its administration. Croatia also needs to identify legal and institutional priorities to be addressed in future to cope with the developments in the veterinary and phytosanitary sectors. Special attention should be paid to training inspectors and staff in the administrations, to modernise laboratories and to support efforts to bring the food processing sector in line with EU public health requirements.

Chapter 8: Fisheries

The *acquis* on fisheries consists of regulations, which do not require transposition into national legislation. However, it requires the introduction of measures to prepare the administration and the operators for participation in the Common Fisheries Policy (in the areas of market policy, resource and fleet management, inspection and control, structural actions and state aid). In some cases, existing fisheries agreements or conventions with third countries or international organisations need to be adapted.

The *Stabilisation and Association Agreement / Interim Agreement* regulate preferential trade of fisheries products.

Concerning **resource and fleet management**, in Croatia there are around 3,150 vessels and boats (832 trawlers, 332 purse seines and 1,999 multi-purpose vessels). The basic legislation

in this area consists of the Marine Fisheries Act and the Freshwater Fisheries Act. Commercial fishing requires possession of the relevant license, which, for small-scale fishing, can be issued only to Croatian citizens. Fishing tools and gears are regulated through an Ordinance on Commercial Marine Fisheries. There is no quota system, except for large pelagic species. Specific provisions are laid down for tuna fishing. Croatia has a fleet development programme directed to increase catch and consumption of small pelagic species that are shared stocks with the other countries around the Adriatic Sea. This programme foresees, in the period 2004-2009, the construction of 30 new vessels (90-120 Gross Tons) against withdrawing of an unspecified amount of old fleet capacity. However, this programme is in contrast with scientific advice agreed by the General Fisheries Commission for the Mediterranean (GFCM). Vessels smaller than 29 kW are authorised to trawl fishing for picarel in coastal areas within 1 nautical mile from the coastline.

The most important fishing activities concern small blue pelagic species (pilchard and anchovy) through purse seine nets and drift nets; to large pelagic fish (tuna) through purse seine nets; and to shrimps, hake and mullet through trawling nets. Beach seine, trammel-net and gillnet fisheries are widespread.

The Ministry of Agriculture administers the fisheries sector through a central department (mainly in charge of legislation and co-ordination) and seven field offices (mainly in charge of license issuing and data collection). Furthermore, an independent State Inspectorate is in charge of control of commercial activities in all areas, including fisheries, although there is no unit with specific responsibility for fisheries inspection. Therefore a limited number of inspectors perform, among other tasks, fisheries inspection activities. The currently available equipment is inadequate and there is no vessel monitoring system. The Maritime Police, under the Ministry of the Interior, is responsible for inspections at sea. Although co-operation between the two services exists, co-ordination of activities does not seem to be sufficiently developed. Overall, the inspection system currently in place raises serious doubts on its effectiveness in terms of staff, equipment and co-ordination of the various administrative services involved.

The Croatian fleet register is kept manually by each port authority. Each vessel is also registered in the computerised database of the register of licenses for commercial fishing. Croatia is preparing to introduce an operational electronic fishing vessel register in conformity with the *acquis*.

Croatia should clarify the licensing of its small scale fisheries fishing for commercial purposes. It should also demonstrate its ability to correctly measure and control capacity and fishing effort of their fleet. There are three types of fishing licenses: commercial, small scale and sport and recreational fishing license. An applicant for commercial fishing license must be registered in the Small Enterprises Register. A license is also needed for fish rearing.

In Croatia the **structural actions** will be managed by the Ministry of Agriculture.

With regard to **State aid to the fisheries sector**, Croatia has a wide range of schemes to support fishing, rearing and processing of fish, namely for rearing autochthonous species. Schemes vary from market and price policy measures to structural policy measures and aids for aquaculture and freshwater fishing. Some of these measures will need to be brought into compliance with the *acquis*.

Concerning **international fisheries agreements**, Croatia is a member of the International Commission for Conservation of Atlantic Tuna (ICCAT) and of EUROFISH. It is also a

member of the General Fisheries Council for the Mediterranean (GFCM) and has ratified the autonomous budget for this organisation. The only bilateral agreement in force is a transitional cross-border regime agreement with Slovenia.

On 3 October 2003 the Parliament unilaterally declared a **protected ecological and fishing zone** in Adriatic Sea. The expanded jurisdiction will come into force one year after its proclamation. It seems to include the interdiction of undertaking any type of scientific investigation by foreign vessels in the zone, unless authorised by Croatian authorities. It is regrettable that Croatia decided to declare a protected ecological and fishing zone in the Adriatic Sea without appropriate dialogue and co-ordination with the other countries concerned.

Conclusion

The Croatian fisheries sector is undergoing significant development. The catches of small pelagic species and the number of fishing vessels are being increased. Progress has been made in establishing a computerised fishing vessel register. However, such developments neither correspond to a precautionary strategy nor are linked to specific scientific findings.

Croatia will have to make further efforts to align its legislation with the *acquis* in this area and to effectively implement and enforce it in the medium term. In particular, these efforts should be directed to put in place adequate structures to manage market instruments, Community funds and to ensure appropriate controls, also including a satellite monitoring system. A solution to the declaration of a protected ecological and fishing zone needs to be found within the framework of the conclusions of the Venice Conference on the Sustainable Development of Fisheries in the Mediterranean.

Chapter 9: Transport

EU transport legislation aims at improving the functioning of the Internal Market by promoting efficient and environment- and user-friendly transport services. The transport *acquis* covers the sectors of road transport, railways, aviation, maritime transport and inland waterways. It covers technical and safety standards, social standards, and market liberalisation in the context of the European Single Transport Market.

The *Stabilisation and Association Agreement* contains provisions concerning land transport, relating inter alia to infrastructure development, the promotion of rail and combined transport as well as to easier market access, facilitation of transit and technical, environmental and social standards in the field of land transport.

Croatia invests a significant percentage of its GDP in **transport infrastructure**. In general, Croatia has sufficient transport capacity in all modes of transport. However, much of the infrastructure is only in fair or poor condition. The core transport network has already been defined with the Commission in the framework of establishing a strategic approach to developing a core infrastructure transport network in the region.

In the area of **road transport**, rules are already applied that are close to the *acquis*. Access to the road goods and passenger transport market is regulated and admission to the professional rules are applied, both for national and international operators. However these would still need to be further aligned with the *acquis*. In the area of the *social acquis*, Croatia is moving towards a Community approach on driving times and rest periods; Croatia requires the use of

a tachograph; it applies the terms of the European Agreement concerning the Work of Crews of Vehicles Engaged in International Road Transport (AETR) also to the national transport. Also in the field of *technical acquis*, Croatia is moving towards a Community approach, by applying e.g. the terms of the European Agreement concerning the International Carriage of Dangerous Goods by Road (ADR), and by having national legislation close to but not fully compatible with the *acquis* on roadworthiness inspection, driver licensing, weights and dimensions and speed limitation devices. As regards the *fiscal acquis*, Croatia would have to align the level of both annual vehicle taxes and user charges with the *acquis*. In addition, the issue of discriminatory nature of charges (additional charges for foreign registered vehicles) would need to be resolved.

As far as *administrative capacity* is concerned, responsibilities in the road transport sector have recently been concentrated in the Ministry of Maritime Affairs, Tourism, Transport and Development. It will be essential to ensure effective co-operation between this Ministry and the Ministry of Interior (responsible for the police), as well as a sufficient level of checks in order to enforce EU standards in the field of social legislation and technical requirements.

In the **rail sector**, the *acquis* concerning the separation of accounts between the infrastructure management and the railway operations has been adopted. The incumbent (still integrated) operator (Hrvatske Željeznice) conducts its management autonomously, but, being entirely State-owned, under the supervision of a 'supervisory board' appointed by the government. The financial position of this company, which is currently being restructured, remains precarious. The recent EU rail legislation (first railway package) has been incorporated into Croatia's legislation in this area, which will be implemented as of 2005, including non-discriminatory access to the national network. However, most secondary legislation (i.a. concerning the independence of the allocation of capacity) remains to be adopted. Croatia would also still need to align its legislation with the *acquis* on interoperability.

Administrative capacity in this area will need to be further strengthened, also in light of the implementation of the new railway *acquis*.

The **inland waterway transport sector** in Croatia is relatively small, with only a limited part of the Croatian fleet being able to operate on the main Community waterways. The ownership of infrastructure and ports is separate from fleet ownership. Social rules are already being aligned with the *acquis*, whereby Croatian legislation on access to the profession includes numerous additional and special requirements. Further alignment would have to take place. As regards the technical requirements for ships, Croatia already applies UN ECE rules equivalent to the *acquis*. The same applies to the transport of dangerous goods.

The *administrative capacity* in the inland waterway sector seems to be adequately ensured at ministerial level and by the Croatian Shipping register.

In the **aviation sector**, a significant part of the *acquis* remains to be transposed, such as provisions on ground handling, slot allocation, computer reservation systems and fares. Although Croatia is a member of the International Civil Aviation Organisation (ICAO) and the European Civil Aviation Conference (ECAC), it is not yet a full member of the Joint Aviation Authorities (JAA), which implies that Croatia will still need to pursue further alignment with safety rules. Also the alignment with state aid and competition rules will be an area requiring further attention. In addition, a comprehensive aviation agreement providing reciprocal aviation market access should be negotiated with the EU.

The *administrative capacity* needs to be strengthened and the roles and responsibilities of the different organisations (Civil Aviation Authority, Department for the Investigation of Aircraft Accidents, Ministry of Maritime Affairs, Tourism, Transport and Development) need to be further clarified.

In the field of **maritime transport**, most of the legislation governing the technical standards of this sector is compliant with the respective standards of the International Maritime Organisation (IMO) and the International Labour Organisation (ILO), of which Croatia is a member, in particular with regard to safety and seafarers' training and social standards. This would suggest that Croatia should not meet major difficulties in aligning its legislation with the *acquis* in the safety and social area in the medium term. Nevertheless, further alignment with the *acquis* would be required as regards vessel registration conditions, public service obligations and contracts, and certain elements of social legislation (e.g. hours of work on board national ships, maritime education, training and certification of seafarers). According to statistics for 2002 under the Paris Memorandum of Understanding on Port State Control, the percentage of Croatian flag vessels detained following Port State control was 8.9%. This compares with an average for EU-flagged vessels of 3.5% in 2002. The Croatian flag is on the grey list of the Paris Memorandum of Understanding.

The administrative capacity would need to be strengthened in order to ensure that Croatia will be able to meet the *acquis* requirements in the areas of Port State Control and Flag State implementation. In addition, unrestricted access to maritime cabotage services should be ensured.

Conclusion

Croatia will have to make further efforts to align its legislation with the *acquis* in this area and to effectively implement and enforce it in the medium term. In particular, these efforts should be directed to continue alignment in the aviation sector. In order to ensure effective implementation of the *acquis*, Croatia's administrative structures would need to be further strengthened.

Chapter 10: Taxation

The *acquis* on taxation covers extensively the area of indirect taxation, as concerns VAT (value-added tax) and excise duties. It lays down definitions and principles of VAT, while excise duties on mineral oils, tobacco products and alcoholic beverages are subject to EU directives as concerns the structures of the duties, the levels of minimum rates and the holding and movement of excisable goods. As concerns direct taxation, the *acquis* covers some aspects of corporate taxes and aims mainly at removing obstacles to cross-border activities between enterprises. Finally, the Community legislation in the area of administrative co-operation and mutual assistance provides tools to avoid intra-Community tax evasion and tax avoidance for both direct and indirect taxation.

In the area of **indirect taxation**, Croatia has a *value-added tax (VAT)* system in place, which was first introduced in 1995 and further amended several times. The current VAT system is based on EU VAT legislation and thus represents a good starting point. In parallel with VAT, a limited system of taxes on sales of goods and services still exists, although the sales tax accounted for only 0.16% of general government revenue in 2002 while VAT accounted for 31.3%. The definitions of taxable scope, taxable persons, VAT liability and the provisions on the place of supply are similar to what is provided for in EU legislation. Foreign entrepreneurs

who are not residents may register in Croatia for VAT purposes. A taxable person is not obliged to register for VAT when his annual turnover does not exceed HRK 85,000 (approx. €11,500), which is above the threshold provided for in the *acquis*.

Currently Croatia applies a standard VAT rate of 22% and no reduced rates are applied, which is in compliance with the *acquis*. However, a zero rate is applied to a range of specified goods and services: bread, milk, books, scientific journals and educational supports, pharmaceuticals and medical equipment to alleviate or treat disability, cinemas and tourist services if purchased from abroad. The application of a zero rate is not compatible with the *acquis*. There is no discrimination against imported goods, as the rate applicable is the same as that applied to similar domestic products. The exemptions from VAT without the right to claim an input credit on the supply of certain goods and services are quite similar to what is provided for in the *acquis*, but further alignment is necessary.

In accordance with the *acquis*, supplies of goods to and within free zones and free and bonded warehouses are exempted. However, the territorial application of the VAT Act excludes the free zones established in Croatia, something which is not in line with the EU *acquis* (see also Chapter 25 – Customs union).

While taxable persons are entitled to deduct VAT incurred on their purchases of goods and services for business purposes, the Croatian VAT Act does not allow refunds to non-established traders, with very limited exceptions. The latter provision is contrary to Community legislation. Furthermore, the VAT Act does not contain any of the special VAT schemes provided for in the *acquis*; the only special scheme concerns second-hand cars.

As regards administrative capacity, the Tax Administration, an administrative organisation within the Ministry of Finance, is competent for direct taxes and VAT (except for VAT on imports, collected by the Customs Administration). It consists of Headquarters, 20 regional offices and 121 branch offices. The tax administration's competences and powers as well as taxpayers' rights and obligations are clearly defined.

According to available data, the size of the grey economy was significant in the 1990s, but seems to have decreased. The efficiency of tax collection by the due date (85%) is far lower than the average in the EU (93%). The control strategy for VAT and direct taxes, determined by provisions of the General Tax Act, needs to be further developed and strengthened. An annual Inspection Action Plan is established for the controls, where selection is based on a number of different criteria. A substantial increase in the number of tax inspectors seems necessary and is foreseen. At the local and operational level, employees of the Tax Administration are responsible for all taxes connected with the allocated taxpayers, although inspectors do specialise according to the size and/or the activity of the taxpayers.

There is the possibility both to appeal against decisions of the Tax Administration and to bring taxpayers to court for tax fraud, but – at least for the latter – the procedures are slow and result in inefficiencies. The main tax evasion problems concern VAT. The independent Department for Tax Crimes Investigation at the central office and its regional offices in Zagreb, Rijeka, Split and Osijek are not yet well-organised and do not have a sufficient number of fraud specialists at their disposal. Moreover, cooperation between the tax administration, the police, the prosecutor's office, investigating judges and courts of first and second instance is far from optimal and leads to very long delays.

As concerns *excise duties*, all products that are part of the EU harmonised excise system (i.e. alcohol and alcoholic beverages, tobacco products and mineral oils) are subject to excise

duties. Excise duties accounted for 9% of total general government revenue in 2002 (including a number of additional excisable products under Croatian law). The adoption of a uniform act governing excise duties is planned and should bring the legislation closer to the *acquis*, also by introducing a duty-suspension system for domestic movements based on the EU *acquis* and allowing more efficient control procedures.

Extensive adjustments will need to be made to the tax base, structures and definitions of most EU harmonised excisable goods. Concerning alcohol and alcoholic beverages, Croatia appears to allow an exemption for home-made production for own consumption of all categories of alcoholic beverages except beer. The EU *acquis* does not provide for such an exemption in the case of intermediate products and spirits. Contrary to the *acquis*, Croatia also exempts from duty small breweries producing less than 1500 litres per year. As for tobacco products, exemptions from duty will need to include denatured manufactured tobacco. Concerning mineral oils, all kinds of heating oils are exempt from excise duties. The scope of the exemptions is not in line with the *acquis*.

As regards the level of excise duties, the rates applied to the above mentioned categories are in some instances below the EU minimum levels. This concerns in particular cigarettes and hand rolling tobacco, whilst a comparison with the EU minimum rates for alcoholic products, particularly beer, is not yet possible because of the different structure of the duties. Concerning mineral oils, the rates of excise duties do not differentiate with regard to the use of the mineral oil. Liquid petroleum gas intended for any purpose – as well as other mineral oils – is taxed at a significantly lower level than the minimum rates provided for by the *acquis*. The level of rates applied to domestic and imported similar products is the same. The Croatian duty-suspension scheme will need to be brought in line with the requirements of the *acquis*. In particular, the present excise duty suspension arrangements are not available to imported excisable products and this will need to be rectified.

The Customs Administration has been responsible for excise duties since January 2002. However, the excise duty service does not yet exist as a real functioning body within the Administration, since it employs only 2 persons. At the operative level, only 10 customs offices deal specifically with excise duties. Hiring of new staff and systematic training of employees for both collection and control of excise duties is thus necessary and planned. Furthermore, it appears that Croatia is facing important problems linked with the smuggling of tobacco products – and to a lesser extent, of alcohol – through its borders.

As concerns **direct taxation**, some provisions concerning the taxation of interests, royalties, dividends and fees paid by Croatian corporations to non-residents need further alignment with the Interest and Royalties Directive and with the Parent/Subsidiary Directive. Furthermore it should be recalled that the Savings Directive requires the introduction of a cross-border exchange of information among Member States concerning the payment of interest to EU resident individuals.

The transposition of the Merger Directive should enable the removal of tax obstacles to cross-border business reorganisations. With reference to the European Court of Justice, it has to be recalled that although direct taxation falls within the competence of the Member States, the latter must nevertheless exercise that competence consistent with Community law and therefore avoid any open or hidden discrimination by reason of nationality.

At the moment Croatia applies five preferential schemes for profit and income tax. It should be recalled that Croatia will have to comply with the principles of the Code of Conduct for

business taxation, and notably not to introduce new tax measures and to roll back existing legislation which may be contrary to the principles of the Code of Conduct.

The collection of direct taxes is the responsibility of the Tax Administration (see above, administrative capacity in the area of VAT).

As concerns **administrative co-operation and mutual assistance**, Croatia's experience is so far very limited for both VAT and excise duties. Actions in this area will need to be taken, concerning in particular the development of IT systems for the exchange of information. In this respect, the VAT Information Exchange System (VIES), the application for VAT on e-services, the System for Exchange of Excise Data (SEED) and the computerised system for the intra-Community movement and monitoring of excisable goods (EMCS) will need to be set up and fully operational by the date of accession.

Conclusion

Further amendments to the VAT system will be necessary to bring it in line with the *acquis*. Attention must be paid to the existing regime for free zones, which are not presently considered as part of Croatian territory for VAT purposes, to ensure that their regime is fully aligned with the *acquis* and that they are properly controlled. VAT zero rates and the sales tax will have to be abolished. Even though an excise duty system exists, alignment with the *acquis* will require considerable efforts in all areas and product categories. In the area of direct taxation further efforts will be necessary in order to achieve full alignment with the *acquis*, including the case law of the European Court of Justice.

The capacity of the Tax Administration requires important further strengthening, especially regarding collection and control functions. The administrative capacity of the Customs Administration covering excise duties is insufficient and important efforts will be needed, in particular to introduce a more adequate organisational structure and service, with sufficient and trained staff. To increase the effectiveness of the fight against tax fraud, the complicated nature of the procedures to prosecute fraud, combined with the weakness of the Croatian judiciary, needs to be addressed.

Overall, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the area of taxation in the medium term. Particular attention should be devoted to IT interconnectivity if Croatia wants to be in a position to meet its obligations in this specific field by accession.

Chapter 11: Economic and Monetary Union

EU legislation on Economic and Monetary Union (EMU) contains specific rules requiring the independence of central banks in Member States, prohibiting direct financing of the public sector by the central banks and prohibiting privileged access of the public sector to financial institutions. Moreover, all Member States are bound to lay down specific measures necessary for the protection of the euro against counterfeiting. These rules must have been implemented by the date of accession. Upon accession, new Member States will be expected to co-ordinate their economic policies and will be subject to the provisions of the Stability and Growth Pact and of the Statute of the European System of Central Banks. They are also committed to complying with the criteria laid down in the Treaty in order to be able to adopt the euro. Until their adoption of the euro, they will participate in Economic and Monetary Union as a

Member State with derogation and shall treat their exchange rates as a matter of common concern.

In Croatia, **central bank independence** appears to be largely in place. Indeed, the Act on the Croatian National Bank of 2001 seems to be almost compliant with EU legislation. It stipulates that the Bank (Hrvatska narodna banka - HNB) shall neither seek nor take instructions from other authorities. The Bank is financially independent and is the only institution responsible for monetary and foreign exchange policies in Croatia. The primary objective of the Bank is the achievement and maintenance of price stability.

However, some provisions of the HNB Act need to be further improved. In terms of institutional independence, the provisions on central bank independence should be further aligned with the *acquis*. In particular, the reporting obligations for the HNB on monetary policy should only be ex-post, in order to prevent any possibility of external influence. In the area of personal independence, the provisions concerning grounds for dismissal of Council members should reflect the ESCB Statute more closely.

As regards the prohibition of **direct financing of the public sector by the central bank**, the law explicitly prohibits extending credit directly to the Republic of Croatia. However, the possible coverage of a shortfall between income and expenditures of the HNB by debt securities of the Republic of Croatia could involve a form of monetary financing to the extent that the HNB is obliged to acquire them.

Regarding the prohibition of **privileged access**, the Insurance Act and the Act on Mandatory and Voluntary Pension Funds contain floors or thresholds with respect to public Croatian securities. This is tantamount to creating privileged access for the Republic of Croatia compared to other states and institutions. In addition, the Savings and Loan Co-operatives Act allows investing available funds in the securities of the Republic of Croatia only. These acts will need to be adapted.

Croatia has established procedures for the **protection of the euro** against counterfeiting. Suspect euro specimens are sent to the Criminal Forensic Centre for technical analysis, which then sends its findings to the HNB and the Crime Investigation Department of the Police. Although the capacity for technical analysis exists, the establishment of a full-fledged National Central Office on counterfeiting should be considered. Agreements foresee the transmission of related information to Europol and Interpol. While credit institutions have an obligation to withdraw suspect banknotes from circulation and to hand them over to the competent authorities, no sanctions are specified if this obligation is not respected. The legislation will need to be changed in this regard.

Conclusion

Croatia should be able to fulfil the requirements of the *acquis* in the field of Economic and Monetary Union in the medium term. However, some aspects of the legislation on central bank independence, monetary financing, privileged access of the public sector to financial institutions and protection of the euro need to be further aligned. Croatia's preparation for participation in the third stage of EMU as a Member State with a derogation should not pose major problems prior to accession.

Chapter 12: Statistics

The *acquis* in the field of statistics requires the adoption of basic principles such as impartiality, reliability, transparency, confidentiality of individual data and dissemination of official statistics. It also covers methodology, classifications and procedures for data collection in various areas such as statistical infrastructure, macro-economic and price statistics, business statistics, transport statistics, external trade statistics, demographic and social statistics, agricultural statistics, environment statistics, science and technology statistics and regional statistics. The focal point of the statistical system of a country is the National Statistical Institute, which acts as the reference point for the methodology, production and dissemination of statistical information.

As regards **statistical infrastructure** in Croatia, the legal framework was modernised when a new Official Statistics Act entered into force in June 2003. The principles of reliability, professional independence, statistical confidentiality and individual data used for exclusively statistical purposes are enshrined in this law which is fully compliant with EU principles.

The Central Bureau of Statistics (CBS) plays the leading role within the **statistical system**. The Director General of the CBS and his Deputy are appointed by the Government. Forming an important component of the statistical system in Croatia are the 21 regional offices which carry out certain tasks for the CBS but administratively are not part of it. As foreseen in the law, a Statistical Council was created in October 2003 and is supposed to significantly improve relationships between producers and users of statistics as well as involve more closely the academic community. Co-ordination with other producers of official statistics remains problematic and can be seen as the main weakness of the Croatian statistical system. The recent creation of 15 statistical advisory committees, covering all main statistical subject areas, should improve the situation. These committees should assist the CBS in strengthening its co-ordinating role and in promoting the use of common and harmonised methodologies. As a consequence of the Official Statistics Act, a strategic management cycle concept has been recently adopted and Croatia is working on long-, medium- and short-term strategic documents for Croatian Official Statistics. The CBS employs 396 persons as regular staff, of whom 42% have a university degree. Fluctuation is higher in the CBS than in other parts of the administration. There is no specific training programme organised by the CBS in official statistics, and there are no rulebooks which would translate the fundamental principles or the statistical law into rules of behaviour for staff.

As regards **classifications**, national classifications of economic activities and of products by activities appear to be in line with EU requirements. A new proposal for a “statistical region nomenclature” (NUTS – *Nomenclature des unités territoriales statistiques*) in Croatia needs to be submitted to the Commission in order to agree on a NUTS breakdown.

The production of **regional statistics** in accordance with the future agreed NUTS needs to be strengthened in particular in view of calculating, at NUTS II Level, GDP per capita on the basis of gross value added figures.

Concerning **demographic and social statistics**, the latest population census was carried out in 2001 and the next one should take place in 2011. In the meantime external migration statistics needs to be improved in order to be able to produce more reliable current population statistics on an annual basis with the census as the starting point. A Labour Force Survey has been conducted every six months since 1996 on a sample of 8500 households and meets ILO and Eurostat standards.

With regard to **macro-economic statistics**, significant improvements still need to be made to achieve a sufficient quality and comparability of national accounts based on the ESA 95 methodology. Administrative capacity within the CBS needs to be reinforced. A Harmonised Consumer Price Index is not yet available.

As regards **business statistics**, the existing business register does not yet meet statistical needs. An economic census should be carried out in order to build a homogeneous basis for a statistical register.

In the field of **transport statistics**, administrative capacity within the CBS needs to be reinforced in order to overcome the lack of information in the air and maritime transport, passenger and goods transport and road accident statistics.

In the field of **external trade statistics** the quality of statistics is already quite good and the production system largely harmonised with the *acquis*. Further improvements should concentrate on greater methodological harmonisation with EU standards, data quality and developing tools for mirror statistics with other SAP and EU countries.

Further progress on upgrading Croatian **agricultural statistics** will be built on the results of the agricultural census which took place in June 2003. Efforts should focus on establishing a farm register and on improving the IT situation in the sector.

Environment statistics and **science and technology** statistics need to be developed further as new *acquis* in these two statistical areas has recently been reinforced.

Conclusion

In order to ensure further improvements and developments of statistics, Croatia needs to reinforce human resources in key-areas such as for example macro-economic statistics. Also training of staff has to be developed considerably. In this context, the reorganisation of regional offices remains a pending issue that needs to be solved. Efforts are also needed to upgrade the IT infrastructure.

Furthermore, in order to achieve full compliance with the *acquis*, close cooperation between the CBS and other producers of statistical data in the Croatian administration will be required. The role of CBS as focal point for the Statistical System of Croatia needs to be enhanced.

Overall, the statistical system of Croatia has made remarkable and rapid progress towards compliance with international and EU standards. If it continues its efforts, Croatia should not have major difficulties to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term.

Chapter 13: Social policy and employment

The *acquis* in the social field includes minimum standards in areas such as labour law, equal treatment of women and men in employment and social security, and health and safety at work. Specific binding rules have also been developed in public health (on tobacco control and surveillance and control of communicable diseases) and recently also with respect to non-discrimination on grounds of racial or ethnic origin, religion or belief, disability, age or sexual orientation. The European Social Fund (ESF) is the main financial tool through which the EU supports the implementation of its Employment Strategy and contributes to social inclusion efforts (implementation rules are covered under Chapter 21, which deals with all structural

instruments). The Member States participate in social dialogue at European level and in EU policy processes in the areas of employment policy, social inclusion and social protection.

As regards **labour law**, the national legislation of Croatia seems to cover most of the basic principles laid down by the EU labour law directives in areas such as working time, information and consultation of employees, and information for workers on individual employment conditions. In the event of insolvency of their employer, workers are guaranteed a certain level of compensation, paid by the Development and Employment Fund. However, a number of adjustments to the national legislation will still be necessary in the field of labour law in order to fully transpose and implement the *acquis*. In addition, Croatia does not appear to have legislation similar to the directives on European Works Councils and the posting of workers.

In the area of **equal treatment for women and men**, the Constitution prohibits all forms of discrimination and Croatia has ratified a number of international conventions. Croatia is also bound by Article 8 of the European Social Charter and Article 1 of its Additional Protocol. The principal laws which prohibit discrimination on grounds of sex in relation to employment are the Labour Code and the Gender Equality Act. In general it appears that Croatia has the necessary basic legislation in place to a considerable extent. Legal adjustments are necessary, however, e.g. in connection with the removal of over-protection of women. The different pension ages for men and women in the police, military and the civil service may have to be adapted and the third (voluntary) pillar of the pension scheme may have to be examined in this light.

A number of institutional structures have been created specifically to promote, implement and monitor equal treatment for women and men (i.a. the Committee on Gender Equality of the Parliament, the Commission on Gender Equality Issues and the Office for Gender Equality of the Government, the Ombudsman for Gender Equality). In addition, a number of other structures work in the area of human rights generally, including equality, for example the Co-ordination Committee on Social Affairs and Human Rights and the Government Office for Human Rights.

A basic legal framework for **health and safety at work** is provided by the Occupational Health and Safety Act, which also covers the self-employed, as well as by a number of other legal texts that are only partially aligned with EU legislation. Further efforts will be needed to transpose the EU directives on health and safety in areas such as asbestos, noise, chemical agents, carcinogens and work equipment.

The Labour Inspection is in charge of health protection and safety of workers in most areas of the economy. While the basic structure is in place, the number of inspectors is low (78 inspectors in relation to more than 1.2 million workers). The administrative capacity of the Labour Inspection therefore needs to be strengthened in terms of staff and also equipment. Moreover, its ability to enforce effective and dissuasive sanctions is limited because of the deficiencies in the judicial system. Courts often take decisions after long delays and tend to impose low punishments.

Social dialogue is quite developed in Croatia, both between the State and the social partners and between the State and other economic and social actors within a multipartite process. Bipartite dialogue is also developing. There are six trade union organisations, one of which (Association of Autonomous Trade Unions - SSSH) has an observer status with the European Trade Union Conference (ETUC). There are two employers' organisations, one of which (Croatian Employers Association - HUP) has an observer status with the Union of Industrial

and Employers' Confederations in Europe (UNICE). Tripartite consultations take place within the Economic and Social Council and in three different committees of the Croatian Parliament. The Government also consults the social partners through the management boards of certain funds and institutions, such as the Croatian Pension Fund, the Croatian Health Insurance Fund, the Media Council and the Employment Service.

Autonomous social dialogue seems to develop at company, local, branch and national levels. 142 social partner organisations have been created so far, although only a limited number of branches are covered. Collective agreements seem to be concluded mainly at company level and are recorded by the Ministry of Economy, Labour and Entrepreneurship. The coverage of collective agreements is about 60%. Efforts towards the creation of an autonomous bi-partite dialogue, especially at branch level, should be strengthened.

Croatia is currently reforming its **health** system. The reorganisation of the Health Insurance Fund in 2003 as a key financial source of the reform is an essential part of the process. The orientation of measures taken to improve the health status of the Croatian population would seem to be appropriate (emphasis on health promotion, prevention of ill health, access for all). However, it would seem that additional financial, material and human resources are needed to bring the health care reform to a successful conclusion and to improve the health of the population.

A system of control of *communicable diseases* is established by the Act on the Protection of the Population from Infectious Diseases and other legislation. A legal basis for the development of plans for eradicating communicable diseases exists and an immunisation programme developed according to WHO recommendations and guidelines is in place. The list of the diseases covered by State control should be modified and the EU case definitions implemented into the reporting system to allow the comparability of data. There is capacity for continuous monitoring, and there is co-operation between the health care system and veterinary services. Communicable diseases do not seem to present a serious problem in Croatia. The data in this respect are satisfactory, and morbidity trends are favourable. However, additional efforts are required in order to prepare the system for cooperation with EU structures, such as development of a nosocomial diseases control system, development of a system for anti-microbiological resistance surveillance or development of an action plan for an outbreak on the national level.

Several pieces of legislation cover the area of *blood* quality. They would seem to be broadly in line with the Blood Directive. There may be a shortage of material resources to fulfil the requirements in this area. Croatia would also need to draft and implement new legislation in order to align itself with the recently adopted directive concerning the quality and safety of tissues and cells.

The Croatian Act on Restriction of *Tobacco* Product Use of 1999 is broadly in line with the provisions of the Tobacco Products Directive. However, it does not meet all the requirements of the *acquis* in particular with regard to warning labels, carbon monoxide yields and misleading descriptors. The maximum nicotine and tar yields are also higher than provided for by the Directive. The Act includes a ban on advertising that is stricter than that provided for in the Advertising Directive. The Act also includes provisions on smoke-free environments, sets an age limit for tobacco purchasers and foresees smoking prevention measures.

Regarding **employment policy**, the unemployment rate stood at 14.1% in the first half of 2003 (ILO methodology), although it has been decreasing over the past two years. Activity

rates remain low and are a source of concern. Employment policy consists mainly of a number of active labour market measures (e.g. for young persons without work experience and for new university graduates), which are implemented by the employment services. Social and regional partners are involved in the process. While a lack of funds tends to restrict the scope of these measures, employment offices have undergone considerable reform and thus appear to have a basis for effective implementation. No measures seem to exist on behalf of long-term unemployed. Links between employment offices and vocational education and training schools should be strengthened to remedy the current mismatch of skills on the labour market.

Croatia intends to draft a first National Action Plan for Employment (NAPE) based on the revised European Employment Guidelines. The first NAPE should help develop a more strategic approach to employment. In this context, Croatia needs to develop capacity for analysis, implementation and assessment of employment policies.

As regards preparations for the **European Social Fund**, the implementation of active labour market measures is a useful first step. Croatia will have to adapt its structures and legislation in order to create adequate administrative capacity for the management, implementation, monitoring, audit and control of Social Fund-type measures at both the national and regional levels.

Compared to the size of its economy, Croatia has a relatively generous system of **social protection**. Reforms have been carried out over the past few years, including the introduction of a three pillar pension system.

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 their calculation. A specific analysis of social exclusion and poverty in Croatian society is needed as a basis for future programmes for vulnerable groups such as pensioners, long-term unemployed, disabled persons, refugees and Roma, particularly in war-affected regions.

Croatia appears to have made some progress in tackling **discrimination**, although specific legislation has not been adopted. National measures to implement the anti-discrimination provisions need to be taken. Recent amendments to the Labour Code address a number of points covered by the directives (definitions of direct and indirect discrimination, harassment, burden of proof). There do not appear to be any anti-discrimination provisions outside the employment field other than the Constitution, the Criminal Code and international human rights instruments ratified by Croatia. With regard to the equality body required by the directives, Croatia currently has a Human Rights Ombudsman who could be designated as the equality body. (*For the rights of minorities, refugees and Roma, see Part 1, Political Criteria.*)

Conclusion

Croatia has started alignment with the *acquis* in areas such as labour law, health and safety at work, public health, equal treatment for women and men and anti-discrimination, but substantial progress remains to be made. The regulatory and, in particular, administrative framework for the protection of health and safety at work needs to be strengthened. Active labour market measures need to be further developed in order to remedy the current mismatch of skills on the labour market. A more strategic approach to employment needs to be developed and matched by appropriate capacity building for analysis, implementation and assessment. The strengthening of the public employment services should be supported by the

continuation of modernisation initiatives. A specific analysis of social exclusion and poverty in Croatian society is needed. In addition, social dialogue needs to be strengthened and preparations for the implementation of the ESF should be envisaged.

Overall, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the area of social policy and employment in the medium term. Croatia also needs to prepare itself for participation in the co-operation processes developed at European level in the fields of employment, social inclusion and pensions.

Chapter 14: Energy

EU energy policy objectives include the improvement of competitiveness, security of energy supplies and the protection of the environment. The energy *acquis* consists of rules and policies, notably regarding competition and state aids (including in the coal sector), the internal energy market (for example, opening up of the electricity and gas markets, promotion of renewable energy sources, crisis management and oil stock security obligations), energy efficiency and nuclear energy.

Croatia has some domestic energy sources (oil, gas, solid fuels, hydro) but depends increasingly on external supplies, notably for oil. It is an important transit country for electricity, gas and oil. Croatia has relatively small recoverable coal reserves which are estimated at 39 million tonnes, but there has been no solid fuels production in the country since 1997. Hard coal, used for electricity production and the steel industry, is imported in minor volumes, totalling less than 100,000 tonnes per year. Croatia is a member of the Western European electricity networks (Union for the Co-ordination of Transmission of Electricity - UCTE). The country's Energy Sector Development Strategy, covering the period 2002-2012, appears to be generally in line with EU energy objectives. The main energy companies are state owned (Hrvatska Elektroprivreda - HEP - holding company for electricity activities, Plinacro for gas transport and Jadranske naftovod for oil transport). Privatisation in the sector has started with 25% of the shares of the oil and gas company INA. Further privatisation is envisaged. The 40 gas distribution companies are generally owned by the local authorities. The electricity company HEP owns 50% of the shares of Krško Nuclear Power Plant, located in Slovenia.

With respect to **security of supply**, and in particular oil stocks, key legislation is in place and includes, *inter alia*, the Energy Act, the Act on Oil and Oil Products Market, the Strategic Economic Contingency Stocks Act and the Ordinance on Compulsory Oil and Oil Products Stocks Reserves. This framework provides notably for the progressive building-up of compulsory oil stocks (from currently 10 % of the previous year's net imports up to 25 % of the previous year's net imports in 2006). Stocks are generally held by companies. Croatia needs to take further steps towards the *acquis* requirement to hold 90 days of emergency oil stocks. The main administrative bodies in this *acquis* area are the Ministry of the Economy and the State Inspector's Office. Croatia is envisaging the establishment of a separate oil stocks agency. Further strengthening of the administrative capacity appears necessary.

In the field of **competitiveness** and **the internal energy market** Croatia adopted five key acts in July 2001: the Energy Act, the Electricity Market Act, the Gas Market Act, the Act on Oil and Oil Products Market and the Act on Regulating Energy-Related Activities.

The electricity market has been opened up for customers consuming more than 40 GWh per annum. Access to networks is ensured through regulated third party access. Within the electricity company HEP an independent transmission and market operator has been established.

The gas market has been opened up for large customers with an annual consumption exceeding 100 million m³ and for all producers of electricity and heat/electricity from gas. Access to networks is ensured through negotiated third party access.

In both the electricity and gas companies the accounts of the various activities are unbundled. Legislation includes the possibility to prescribe public service obligations and monitoring of security of supply.

Croatia has taken key steps towards its gradual participation in the internal energy market and towards alignment with the Electricity and Gas Directives. Croatia plans to fully open its electricity and gas markets by 2007, broadly in line with the EU requirements. Legislation needs to be further refined, while key secondary legislation remains to be adopted. The possibility to restrict imports and exports of energy products should be eliminated. Croatia should also eliminate price distortions. Gas prices appear to reflect costs, but distortions remain in the area of electricity and district heating.

The Croatian Energy Regulatory Council is a formally independent body which issues licences for energy related activities, supervises tariffs and performs some other regulatory activities. The five Council members are appointed by the Parliament, while its costs are covered by the state budget. There should be no mandatory link from the regulator to the HEP-dominated Energy Institute. Overall, increased powers, training and staff are needed in the regulator and in the Ministry, and their respective roles defined so that no specific review of a regulatory decision may be addressed to the Ministry. Reform will also need to be undertaken in the dominant power generator, HEP.

Croatia applies, on the basis of the Mining Act, a system of non-discriminatory licensing for the prospecting, exploration and production of hydrocarbons, but conformity with the Hydrocarbons Licensing Directive needs to be ensured.

The Regional Energy Market in South East Europe (REM), covering electricity and gas, has put in place a phased transition programme attuned to the specific characteristics of the region. The aim is the reintegration of the state and sub-state energy markets with an eventual movement to adherence to the EU Internal Energy Market. In this context, Croatia is encouraged to rebuild its interconnection infrastructure to its south and to manage the increased trade that will result.

Croatia runs, since 1997, energy efficiency and renewable **energy programmes**. They are based, since 2002, on the Energy Sector Development Strategy. The annual programme budget in 2002 and 2003 amounts to 2.8 million HRK (€380,000), while additional financial means are devoted to legal and institutional work in this area. The legislative framework comprises the Energy Act and the Act on the Environmental Protection and Energy Efficiency Fund. Implementing legislation, aiming at alignment with the *acquis*, is under preparation and is planned to be in force by 2004.

More remains to be done to improve energy efficiency and to promote renewable energy sources. Also legislation needs to be further developed and institutional capacity needs to be strengthened.

In the area of **nuclear energy and nuclear safety**, Croatia does not have nuclear installations or nuclear fuel cycle facilities. However, the national electricity company (HEP) is co-owner of the Krško Nuclear Power Plant (NPP) situated in Slovenia. The Krško NPP Agreement between Croatia and Slovenia, regulating the status and other legal relationship connected with investments, exploitation and decommissioning of the plant, entered into force in March 2003. Croatia has at present no plans to build a nuclear power plant. With respect to radioactive waste management, two storage facilities exist for used radiation sources and low level waste produced in various applications of radiation sources.

The Act on Nuclear Safety, adopted in October 2003, provides the legal framework in the nuclear sector in accordance with international standards, especially the recommendations of the IAEA. Croatia is party to a number of Bilateral Agreements, International Conventions and it is a member of the IAEA.

There is currently no independent nuclear safety regulatory authority. The Ministry of Economy has full responsibility concerning nuclear safety, the licensing of nuclear facilities, including fuel and waste treatment facilities, and implementation of nuclear safeguards. However, the new Act on Nuclear Safety provides for the establishment of a State Institute for Nuclear Safety, which will take over responsibility for activities relating to nuclear safety from the Ministry of Economy. According to the new Act, this nuclear safety regulatory authority shall begin its work no longer than 1 January 2005. The Hazardous Waste Management Agency is responsible for the management of the disposal and storage of hazardous waste, including radioactive waste. The Ministry of Interior is responsible for the adoption and control of protective and security measures in connection with the risk of handling of nuclear material and illicit trafficking. In addition, this Ministry makes decisions on special protective measures with regard to the carriage of radioactive material.

In the area of **nuclear safeguards**, Croatia has signed and ratified a Comprehensive Safeguard Agreement and an Additional Protocol to this agreement with the International Atomic Energy Agency (IAEA). Upon accession, the Euratom Treaty would be directly applicable and Croatia's nuclear operators would have to report all safeguards related information to the Commission, which would in turn report to the IAEA.

Conclusion

Croatia will have to make further efforts to align its legislation with the *acquis* in this area and to effectively implement and enforce it, including Euratom provisions, in the medium term. In particular, these efforts should be directed to legislation and administrative capacity in the area of oil stocks, the internal energy market, energy efficiency and renewable energy and nuclear energy. The actual constitution of 90-days oil stocks should also be ensured.

Chapter 15: Industrial policy

EU industrial policy seeks to enhance industrial competitiveness and rates of employment, whilst operating in markets open to international competition. Its aim is to speed up adjustment to structural change, encouraging an environment favourable to initiative and to the development of undertakings throughout the Community. EU industrial policy mainly consists of policy principles and horizontal and sectoral industrial policy communications. An important element of any industrial policy is the control of State aid and the compatibility of support schemes with EU rules (*see also Chapter 6 – Competition*).

Croatian industry accounts for 25.3% of GDP in 2002. The manufacturing sector consists of about 8,500 enterprises, most of which are privately owned. Employment in industry is at a level of approximately 300,000 persons. Small firms account for more than 90% of all industrial firms, but medium-sized and large firms provide for 84% of industrial employment. The most important sectors are food, chemicals, textile and clothing, and shipbuilding.

The **agri-food industry** is one of the most important and dynamic sectors of Croatian industry. It represents 20.5 % of total industrial production and 17.7 % of total industry employment. The number of companies in this sector has increased by 21 % between 1999 and 2002. Production has increased by approximately 14 % in 2001 compared to 1998. Investments from EU Member States are concentrated on the manufacture of soft drinks, mineral waters and beers.

The **chemical industry** is in an important industrial sector in Croatia with a share of around 11 % in total industrial production and 8 % of total industry employment. The sector consists mainly of privately owned SMEs, with two thirds of the companies in the rubber and plastic sector. The relatively high Foreign Direct Investment (FDI) in the sector in the years 1999 and 2000 is an indicator of competitive upgrading. The trade balance in the sector is largely negative with the EU as the main trade partner.

The **textiles and clothing sectors** provide a relatively large contribution to the Croatian economy with 5.6 % of total industrial production and a share of 17 % of employment. The industrial structure is characterised by private ownership and predominance of small scale enterprises. EU imports have been growing. Further structural adjustments are needed to increase competitiveness in this sector.

The production of Croatia's **shipbuilding industry** amounts to one percent of world output. The sector represents 4.4 % of industrial production and 4.9 % of industry employment. The sector has not undergone privatisation to any significant effect with five out of the six mayor yards still government-owned. Significant amounts of State aid are currently granted to the sector and a restructuring policy to enhance the competitiveness of the sector would need to be implemented in accordance with competition and State aid rules.

The Croatian **heavy industry sector** (raw materials) is small with less than 3 % of industrial production and employment. *Cement* accounts for roughly half of that production, with employment more equally spread over various sub sectors. The Croatian *steel industry* produces reinforcing bars for building construction, mainly for domestic consumption, and seamless pipes, which are mainly exported. The sector represents only about one percent of total industry production and employment. One of the two Croatian steel plants has been privatised. A restructuring and conversion programme for the steel sector will form the basis for Croatia's efforts to fulfil its obligation under Protocol 2 of the Interim Agreement on Trade and Trade-related Matters with regards to State aid.

Pharmaceuticals represent 4 % of industrial production and 1.7 % of industrial employment, both declining the last three years. The sector is characterised by the dominance of one company, representing 70 % of employment in this sector. FDI has been declining; the lead Croatian company has on the contrary made acquisitions in foreign markets.

The **electrical and mechanical engineering** sectors (including radio, television and communication equipment) are already closely integrated with the EU industry. The sector represents 5.3 % of industrial production and 5.5 % of industry employment. Croatia is specialised in metal articles and electrical equipment with a relatively high capacity

utilisation. The EU is the main origin of Croatian imports and the main destination of Croatian exports in these sectors.

The structure of the **construction and construction products industry** is similar to EU Member States and represents about 4 % of GDP. It is very labour intensive representing about one third of total industrial employment. The majority of the companies are SMEs. After a boom in post-war reconstruction, FDI has decreased.

The **information and communication technologies (ICT) industry** is relatively small in Croatia with 3 % of industrial production and 2 % of employment. The trade balance is overwhelmingly negative with EU imports and exports originating mainly from Austria, Germany and Italy, which indicates that intra-industry trade constitutes a large share of ICT trade. Only the telecommunications equipment industry receives any noteworthy foreign capital.

Tourism, Croatia's main export industry, is growing substantially again. After a major decline in the early 1990s due to the outbreak of hostilities in the region, the tourism sector picked up after 1996 and currently accounts for 17 % of GDP. The number of overnight stays reached 45 million in 2002 and the number of foreign visitors increased to almost 7 million. Hotel accommodation capacity is still approximately 25 % lower than in 1991, but there is an important potential for further development provided that progress is made in the privatisation of tourist assets and that investments increase. In 2002, more than 55 % of foreign tourists came from EU Member States.

Croatia has not yet adopted a comprehensive **industrial strategy**, independent from its general economic policy. The framework conditions for industry are implemented through other governmental policies such as the Work Programme of the Government of the Republic of Croatia (2000-2004) and the Principles of the Development of the Republic of Croatia in the 21st Century. The Croatian authorities should adopt and implement a coherent strategy to improve industrial competitiveness in the framework of a better general business environment. This strategy should take into account specific needs and characteristics of individual sectors.

Foreign investment in the manufacturing sector represents 13 % of total FDI. A Trade and Investment Promotion Agency has recently been created, but is not yet fully operational. Further measures should be adopted to stimulate domestic and foreign investment, in particular through simplification of legal and administrative procedures.

As regards **privatisation and restructuring**, a programme for the state privatisation portfolio was adopted in February 2001. High debts, low profitability and excess labour, as well as limited government commitment, contributed to a slower than expected privatisation process. Progress in restructuring the manufacturing sector remains unbalanced. The biggest need for further restructuring and modernisation exists in textiles, steel and shipbuilding.

The central body responsible for the formulation and co-ordination of industrial policy is the Ministry of Economy, Labour and Entrepreneurship, which would need to strengthen its role of co-ordinator. Business associations are consulted by the government, but further efforts are needed to institutionalise business advocacy and public-private dialogue in Croatia. Privatisation is under the chairmanship of the State Privatisation Fund unless stipulate otherwise in specific laws.

Conclusion

Croatia will rapidly need to improve conditions for domestic and foreign investments and to complete the privatisation and restructuring process. If it continues its efforts, Croatia should be able to meet EU-requirements in the field of industrial policy in the medium term.

Chapter 16: Small and medium-sized enterprises

EU SME policy aims to improve the formulation and co-ordination of enterprise policy across the internal market with a view to supporting the development of SMEs. In doing so, it seeks to improve the overall business environment in which SMEs operate. SME policy consists largely of consultation fora and Community programmes, as well as of communications, recommendations and exchanges of best practices.

Croatia endorsed the European Charter for Small Enterprises at the Thessaloniki summit in June 2003. SMEs constitute the large majority of the Croatian enterprise sector, representing 99.6 % of the total number of companies (EU average: 98 %) and 65.7 % of employment (EU average: 66 %). Croatian policy distinguishes crafts and co-operatives as distinct enterprise entities. The framework policy is laid down in several acts, which offer specific legal frameworks and definitions for SMEs.

The Development Programme for Small Entrepreneurship 2003-2006 defines the government's SME strategy, inter alia setting out to further increase the importance of SMEs in the national economy. Between 2000 and 2003, Croatia had a specific Ministry for SMEs, whose functions have been reintegrated into the Ministry of Economy, Labour and Entrepreneurship at the beginning of 2004.

There is no regulatory impact assessment to evaluate the effect of legislation on the **business environment**, although the introduction of such a procedure is in preparation. The quality of legislation and rules affecting business as well as the efficiency of the administration and judiciary in Croatia will need further improvement to provide a favourable business climate.

Concerning **interest representation** and advocacy, membership of chambers is mandatory. The Chambers are organised along types of companies and the general Chamber of Commerce. An original feature of SME representation in Croatia is that both the Chambers for companies and the Chamber for crafts and trades are represented in the working bodies of the Croatian parliament and have a direct say in the drafting stages of new legislation.

The time necessary for **registration** of a company has decreased over the last years but work on simplifying procedures should continue. An e-signature law was passed in January 2002, but virtually no e-business currently takes place and on-line company registration is not possible.

The Ministry of Economy, Labour and Entrepreneurship operates a Loan Programme to **support exports** by SMEs. The Croatian Chamber of Commerce has a Centre for Quality and operates the Euro Info Correspondence Centre. There is no tax exemption for small companies in national taxation. Certain tax relieves serve the purpose of rehabilitation of specific geographical areas or specific categories of people.

Access to finance for SMEs has improved with banks offering relatively low interest rates but the requirement for collateral can still be a hindrance to bank lending. The Croatian Small Business Agency (HAMAG) operates as a de facto public guarantee fund and has issued 3,400 guarantees since 1995 for a value of €87 million.

The Croatian Innovation Technology Development Programme (HITRA) is an attempt to set up instruments and institutions to support **technology transfer to SMEs** with various financial and non-financial stimuli.

Education and training for entrepreneurship is not recognised as a separate and distinct topic in the secondary education curriculum but some donor-supported extracurricular activity exist. The choice of such courses at university level is limited. A range of measures and manuals promoting entrepreneurial activity, sponsored by government, chambers of commerce and business advisory services exists. Surveys on entrepreneurs' skill needs are carried out by the Ministry of Economy and the Croatian Chambers.

Conclusion

Croatia should further adjust its legislation and rules affecting business, improve the administrative and judicial environment and continue implementation of the European Charter for Small Enterprises. Alignment with the new Commission recommendation on the SME definition should be carried out. Overall, Croatia should be able to participate fully in EU SME Policy.

Chapter 17: Science and research

Due to its specificity, the *acquis* in the field of science and research does not require any transposition in the national legal order. Implementation capacity does not relate to the application and enforcement of legal provisions but rather to the existence of the necessary conditions for effective participation in the Framework Programmes. In order to ensure the successful implementation of the *acquis* in this domain, notably the successful association to the Framework Programmes, Croatia will need to create the necessary implementing capacities in the field of research and technological development including an increase of the personnel related to Framework Programmes' activities.

Croatia participates in the 6th Framework Programmes of the European Communities for research and technological development as a third country.

In Croatia, science and research is under the authority of the Ministry of Science, Education and Sport. Advisory bodies for issues of science and higher education are the National Science Council and the National Council for Higher Education. Basic legislation in this sector is the Act on Scientific Activity and Higher Education adopted in July 2003. The technology policy is formulated in the Croatian Programme for Innovative Technological Development.

The Government Expenditure on Research and Development (GERD) was 1.09% of GDP in 2001 (EU: 1.99% of GDP). Estimated business expenditure equals between 32-45% of the amount allocated for RTD from the state budget. The Croatian research system consists of 5 universities, 26 public institutes, 11 research centres in the industry sector, 18 schools of professional higher education, 8 polytechnics, 1 military research centre and 50 others scientific research legal entities.

Full participation in the Framework Programmes should be the first step towards the implementation of the *acquis* in the field of research and requires the development of research policy, infrastructure and the appropriate institutional set-up. It also depends on budgetary availability for the payment of the association fee.

The prospects for integrating science and technology in Croatia into the European Research Area are defined by the Strategy for Development of Science in the Republic of Croatia in the 21st Century and the Act on Scientific Activity and Higher Education. These documents foresee radical changes in order to create an efficient and stimulating system of science and technology based on the EU model. Integration into the European Research Area is supported through the CARDS and TEMPUS programmes.

Conclusion

Greater efforts will be needed to make Croatian research and technological development efficient and competitive at the European level. Successful participation in the Framework Programmes will require thorough preparation. Nevertheless, Croatia is well placed to meet EU requirements in this field in the medium term.

Chapter 18: Education and training

Education, training and youth is primarily the competence of the Member States. The EC Treaty provides that the Community will contribute to the development of quality education and implement a vocational training policy that supports and supplements the action of Member States. The *acquis* consists of a directive on education of the children of migrant workers, and of action programmes and recommendations. Member States need to have the necessary implementing capacity in place to effectively participate in the Community programmes related to this chapter (Leonardo da Vinci, Socrates and Youth).

A new Scientific Activity and Higher Education Act entered into force in 2003, providing a framework for the reform of universities, study programmes and the implementation of the principles of the Bologna Declaration which Croatia signed in 2001. The Tempus programme has contributed considerably to higher education reform and created the basis for cooperation with higher education institutions in the EU.

Croatia's **educational priorities** have been gradually refocused to cope with the needs of a free market economy and to improve the quality of the education and training system. One area that requires particular attention is the teaching of foreign languages in primary and secondary schools.

Few children of EU nationals are enrolled in Croatian schools at present. By the time of accession, appropriate measures for **children of migrant workers** will need to be adopted to meet the specific requirements of the *acquis*.

A serious challenge is posed by Croatia's system of **vocational education and training** (VET) at secondary level. A VET strategy has been commissioned and a process of reform has started, including the establishment of a national VET Council. However, current reform efforts seem insufficient to overcome problems such as the lack of qualified teachers, outdated curricula, low investment levels, the lack of a system of nationally agreed occupational and qualification standards, and insufficient links with the private sector. Improvements in this area will be an essential component of the fight against unemployment.

A structured **youth** policy has been developed and resulted in the adoption of a National Action Plan for Young People in 2003. Becoming an EU Member State would imply that Croatia agrees with the Common Objectives for Participation by and Information for Young People as decided by the Council in November 2003. Croatia already benefits from the third

country strand of the Youth programme and Croatian organisations are active in youth exchanges, European Voluntary Service and support measures.

Conclusion

Croatia should not encounter major problems in this field in the medium term. However, considerable efforts will be necessary to create a modern vocational education and training system in line with EU employment and social policies.

Chapter 19: Telecommunications and information technologies

The *acquis* in the field of telecommunications is aimed at the elimination of obstacles to the effective operation of the single market in telecommunications services and networks, and the achievement of universally available modern services. A new regulatory framework on electronic communications was adopted by the EU in 2002. As regards postal services, the objective is to implement the single market by opening up the sector to competition in a gradual and controlled way, within a regulatory framework which assures a universal service.

The *Stabilisation and Association Agreement* provides for cooperation in the area of electronic communications infrastructures, including classical telecommunications networks and relevant electronic audio-visual transport networks, and associated services, with the objective of ultimate alignment with the *acquis* by Croatia as from the entry into force of the Agreement.

The legal framework for **telecommunication services** in Croatia is regulated primarily by the Law on Telecommunications which entered into force in August 2003. Croatia committed itself in the WTO/GATS to abolish the key telecommunications monopoly by 01 January 2003, a date fixed by the 2000 Croatian telecommunications law for the abolition of the incumbent operators fixed monopoly line. However, administrative arrangements created by the 2000 law did not function well and, in August 2003, it was replaced by a new Law on Telecommunications designed to improve the transposition of the 1998 *acquis* including some parts of the 2002 *acquis*. Amendments will still be necessary to bring the rather burdensome authorisation scheme into line with the *acquis* and to ensure that the universal services provisions are fully compliant including in respect of technological neutrality, affordability and compensation provisions. Croatia still needs to adopt vital secondary legislation so that liberalisation of the market can proceed.

In the basic telecommunications *infrastructure*, in mobile penetration and in the supply of ISDN and DSL services, Croatia is at a level comparable to other countries where the market has been open since 2001.

According to the 2003 Law on Telecommunications, the existing Telecommunications Council and Institute are to be replaced by a new Agency for Telecommunications. For the transposition and implementation of the *acquis*, the Agency will have to be a fully independent *regulatory authority* that has the powers and resources to implement a policy of liberalisation. There should be effective procedures for enforcing decisions of the regulator and also an effective appeals procedure. In particular, the procedures should not create opportunities for using the appeals regime to delay implementation of the regulator's decisions. Co-ordination will be needed between the new regulatory authority and other relevant institutions, such as the responsible Ministry, the Agency for the Protection of Market Competition and the Consumer Protection Council. Moreover, the

Telecommunications Services Users Council remains to be created and structured properly, in order to participate in resolving disputes between providers and users of public telecommunications services.

The practical results in terms of *market entry* since January 2003 have so far been very slight. This has not, however, been simply the result of defective laws and ineffective institutions. There have been several clear opportunities to secure important entries to the market, such as a third mobile operator and a second fixed network operator, but these opportunities were not taken. This throws some doubt as to the level of political commitment to the policy of liberalisation. The main beneficiaries of these delays have been the two companies present on the Croatian national market.

Market opening has therefore been frustrated by a lack of commitment at the political level which, in conjunction with poorly designed regulatory institutions, led to delays in important liberalising measures. However, the rebalancing of the incumbent's prices in preparation for competition is well advanced and the company's indicators show a monopoly in need of competitive stimulus. In addition to its de facto fixed network monopoly, the incumbent's group has 53% of the mobile market and 75% of the Internet service providers' market. Croatia should adopt urgent measures to liberalise its market and to ensure that the incumbent operator is brought under effective regulatory control.

The Croatian legal framework for **postal services** is based on the new Postal Act, adopted in 2003. It approximates Croatia's legislation to the *acquis* to some extent. Nevertheless, significant divergences remain, notably in relation to the scope of the universal service, the limits of the reserved area, authorisation and notification procedures and quality of service. Hrvatska pošta will be the exclusive universal service provider under the new Postal Act.

As regards administrative structures, the Postal Act foresees the establishment of the Council for Postal Services, which will act as the national *regulatory authority*. The Council's powers, as set out in the new Postal Act, are broadly in line with those foreseen in the *acquis*. However, the Council need to be adequately staffed and resourced to ensure an effective regulatory regime. In addition, the operational independence of the Council needs to be ensured.

Conclusion

Croatia will only be able to secure full and effective implementation of the *acquis* in the field of telecommunications if there is significant political support for a policy of liberalisation. The regulatory authority should be properly empowered and resourced and its independence from day to day political concerns should be ensured. Attention should also be paid to provide adequate resources to the national regulatory authority in the field of postal services and to ensure its operational independence.

Overall, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term in the fields of Telecommunications and Postal Services.

Chapter 20: Culture and audio-visual policy

This chapter requires legislative alignment with the Television without Frontiers Directive and capacity to participate in the community programmes Culture 2000, Media Plus and

Media Training. The Television without Frontiers Directive creates the conditions for the free movement of television broadcasts within the EU. It includes basic common requirements concerning jurisdiction, advertising, major events, the promotion of European works, the protection of minors and public order, and the right of reply.

Croatia's **cultural policy** seems to be compatible with Community objectives as defined in the EC Treaty and to rely on instruments and institutional capacities to promote culture and co-operation.

In the **audiovisual** area, a new legislative framework was created in 2003 (*see also Part I, Political Criteria*). The Electronic Media Act regulates the activity of both private and public broadcasters, while the Croatian Radio and Television (HRT) Act covers the status and activity of the public service broadcaster. Other relevant legislation includes the Media Act and the Telecommunications Act. Croatia is a party to the Council of Europe Convention on Transfrontier Television.

The adoption of the new media legislation in 2003 represents an important step forward. The Electronic Media Act is to a large extent aligned with international and European standards and Croatia has made an effort to transpose the provisions of the Television without Frontiers Directive. However, some discrepancies remain in the fields of definitions, jurisdiction, advertising, the promotion of European works, the protection of minors, major events, the right of reply and judicial review. The Electronic Media Act and the Croatian Radio and Television Act will need to be adapted accordingly.

The main regulatory authority should be the Council for Electronic Media, which is foreseen in the Electronic Media Act but whose members have not yet been appointed. The Council will have seven members appointed by Parliament for 5 years on a proposal of the Government. It will be competent for both public and private broadcasters and its powers will include the granting of concessions, monitoring of broadcasters with respect to adherence to the law, and presenting reports to the Parliament. The Council should operate independently, but it remains to be seen whether the political independence and plurality of views of its members can be secured in practice. Similar concerns have been voiced regarding the HRT Programme Council, whose members were appointed by Parliament after a long delay in October 2003.

Conclusion

Provided that the remaining legislative adaptations are made and that the legislative framework created in 2003 is implemented in an effective, predictable and transparent manner, Croatia should be able to meet EU requirements in this field in the medium term.

Chapter 21: Regional policy and coordination of structural instruments

The *acquis* under this chapter consists mostly of framework and implementing regulations, which do not require transposition into national legislation. They define the rules for drawing up, approving and implementing Structural Funds programmes and Cohesion Fund actions. These programmes are negotiated and agreed with the Commission, but implementation is the responsibility of the Member States. It should be noted that the Structural Funds regulations will be revised by the end of 2006 at the latest. It is essential that Member States respect Community legislation in general, for example in the areas of public procurement, competition and environment, when selecting and implementing projects, and have the

necessary institutional structures in place to ensure implementation in a sound and cost effective manner from the point of view of both management and financial control.

Upon accession, Croatia will need to have the **administrative capacity** in place to participate in EU structural policy. It will in particular have to design and implement regional development plans; clearly identify the responsibilities of ministries and other administrative bodies involved in the management of Community funds; ensure close co-operation between the Commission, the competent national and regional authorities, economic and social partners as well as private enterprises involved in the financing of programmes and projects; ensure co-financing of programmes and projects; develop the required financial mechanisms; ensure proper monitoring, control and evaluation of programmes and projects; and present a convergence programme in order to qualify for Cohesion Fund support. Work on capacity building for regional development has begun only recently and relies heavily on CARDS projects that started in late 2003.

Croatia has a two-tier **territorial organisation** with 20 counties at the regional level and, at the local level, 123 self-governing cities (urban areas) and 425 self-governing municipalities (rural areas). At present, no administrative and territorial regions correspond to NUTS II level. However, work on the creation of regions and units that correspond to NUTS II and III levels is underway. No precise data are available on GDP per capita harmonised on NUTS II (or III) level, although regional disparities are generally very large.

Regarding the **legislative framework**, national regional policies are covered by several pieces of legislation (Islands Act, Act on Areas of Special State Concern, Act on Hilly and Mountainous Areas, Act on the Reconstruction of Vukovar and Act on the Regional Development Fund). Specific systems for decision-making, implementation and monitoring are defined by each act. The main mechanisms used to attain the objectives of the legislation are tax relief, although financial support for projects is also provided.

There is no specific law on regional policy. This is not necessary in order to participate in EU structural policy, but existing laws should be brought in line with obligations contained in the structural funds regulations. Croatia intends to prepare a National Development Plan (NDP) between 2005 and 2007. The NDP will be based partly on earlier planning documents, such as the Development Strategy of the Republic of Croatia, the National Strategy for Regional Development, sector strategies and regional development programmes. Work on most of these documents is underway.

Successful preparation for participation in the Structural Funds and the Cohesion Fund is closely connected with alignment with EU rules on public procurement, State aid and environment (*see Chapters 1 – Free movement of goods, 6 - Competition and 22 - Environment*). In particular, preference clauses discriminating against Community companies are not allowed, thorough State aid reviews must be carried out, and environmental impact assessments need to be performed systematically before projects are implemented.

The new Budget Act, which entered into force in July 2003, has introduced multi-annual budget programming. However, there are no legal provisions allowing budget transfers between programmes.

Croatia implements several active labour market measures comparable with those funded by the European Social Fund, but considerable attention will need to be given to human resource development in national and regional development plans.

With regard to the **institutional framework** for the implementation of regional development policy, the Ministry of Public Works, Reconstruction and Construction was appointed as a co-ordinating body in March 2003. The relevant part of this Ministry was absorbed by the Ministry of Maritime Affairs, Tourism, Transport and Development in early 2004. It is responsible for preparing legislation and decisions, managing and monitoring island and regional economic and social programmes and projects and carrying out evaluation. In most cases, implementation of development programmes is the responsibility of various bodies at the regional and local level, while monitoring is largely carried out by the responsible ministries. A formal, Government approved inter-ministerial co-ordination mechanism needs to be established.

There is no clearly defined structure for implementing the **partnership principle**. Coordination between the central and local levels is currently informal and ad hoc. A single partnership structure should be established for each form of assistance, covering the preparation, financing, monitoring and evaluation of the assistance.

There are no proper national systems and mechanisms to ensure the **monitoring and evaluation** of the quality and impact of development programmes. A standardised methodology and common cross-sectoral procedures need to be introduced.

With regard to **financial management and control**, the Central Financing and Contracting Unit of the Ministry of Finance began to implement the first decentralised projects in 2003, but its structure and procedures need to be further refined in order to meet EU requirements. In the future, Croatia should improve its financial management and control systems in line with structural funds requirements.

Progress is also needed on the availability of relevant and reliable regional **statistics**. In particular, Croatia should strengthen its capacity to prepare adequate statistical data (GNP/capita/PPS, unemployment rates) at NUTS II and III levels for the determination of eligible areas and for programming and monitoring purposes.

Conclusion

Croatia's regional policy mechanisms are at an early stage. Considerable and sustained efforts to define strategies, create administrative structures and implement programmes will be necessary to allow Croatia, in the medium term, to apply Community rules and channel the funds from the EU structural instruments.

Chapter 22: Environment

Community environment policy aims to promote sustainable development and protect the environment for present and future generations. It is based on the integration of environmental protection into other Community policies, preventive action, the polluter pays principle, fighting environmental damage at source and shared responsibility. The *acquis* comprises over 200 legal acts covering horizontal legislation, water and air pollution, management of waste and chemicals, biotechnology, nature protection, industrial pollution and risk management, noise and radiation protection.

Ensuring compliance with the *acquis* requires significant investment, but also brings significant benefits for public health and reduces costly damage to forests, buildings,

landscapes and fisheries. A strong and well-equipped administration at national, regional and local level is imperative for the application and enforcement of the environment *acquis*.

The 1994 Environmental Protection Act as amended in 1999 provides the **legal framework** for environmental protection. It needs to be further aligned with the *acquis*. The environmental sector was included in the National Programme for Integration into the EU in 2004 for the first time. Given the amount of environmental legislation in the *acquis*, significant extra priority needs to be given if approximation of legislation is to be timely.

Regarding **administrative capacity**, the Ministry of Environmental Protection and Physical Planning was established in 2000 as a central body of State administration. Under the new Government's recent re-organisation it has become the Ministry of Environmental Protection, Physical Planning and Construction. Staffing levels for environmental protection are low with a significant percentage of staff working on physical planning and construction. A number of other bodies are also responsible for aspects of environmental protection and in 2002 two new institutions (the Environment Agency and the State Institute for Nature Protection) were created but these are not yet fully operational. The environmental administration will need to be strengthened to implement the *acquis*, as well as to ensure necessary planning and preparation of financing strategies. Particular efforts will be needed to ensure that regional and local administrations have the necessary resources to effectively implement their responsibilities.

An Inspection Directorate has been created within the Ministry of Environment; it is organised into regional inspection departments and almost half of the 461 staff of the Ministry were assigned to this directorate in late 2003. Inspection duties are also given to other government departments with environmental responsibilities. However, only 32 inspectors are available to cover sectors other than water quality, physical planning and noise, which is clearly insufficient. The number of prosecutions for breaches of environmental law indicates that enforcement levels are low. This can be attributed to various factors, such as the lack of human and financial resources attached to this activity, the weaknesses in Croatia's legal system and judiciary, and deficiencies in the legislation that prevent efficient enforcement.

Public awareness of environmental issues is starting to grow but public participation in environmental decision-making and public access to environmental information remains weak.

On a regional level, Croatia is participating in and currently holds co-chairmanship of the Regional Environmental Reconstruction Programme (REReP). Croatia also participates in activities of the European Environment Agency financed through CARDS and in the LIFE-third countries programme.

Investment in environmental infrastructure in Croatia is low. Significant investments need to be secured to ensure implementation of the environmental *acquis*. Recent work on prioritising environmental projects should prove useful in this regard.

Integration of environmental aspects into other policies is one of the basic principles of the National Environmental Strategy, which was adopted by the Parliament in 2002, and its implementing document, the National Environmental Action Plan. The environmental strategy is one component of Croatia's overall development strategy and many other sectors (tourism, transport, energy etc.) incorporate environmental protection into their basic goals. It remains to be seen, however, how these strategies will translate into practical measures. On a practical level, indications are that the environment is still not given due consideration when

development takes place in other sectors. A national strategy for sustainable development has not yet been developed.

Regarding **horizontal legislation**, Croatia is a party to the United Nations Framework Convention on Climate Change and has signed but not yet ratified the Kyoto Protocol. Various legal provisions exist to ensure access for the public to environmental information, although the Environmental Protection Act is not yet fully in line with the Aarhus Convention that Croatia has signed. Regulations on Environmental Impact Assessment (EIA) contain provisions on public participation but in practice this right is not widely used. Whilst Croatia has an ordinance on EIA dating from 1984, revisions are needed to bring it into line with the *acquis*. Together with the implementation of the *acquis* on Strategic Environmental Assessment (SEA), this will need to be pursued as a priority. Croatia will need to ensure provisions for public participation in environmental decision making across a range of different areas, including permit procedures and the drawing up of plans in waste, air quality and water pollution by nitrates. This is likely to pose a major challenge.

Air pollution levels have fallen since 1990 due to the decline in heavy industry. Limit values and monitoring systems are being developed to align with the *acquis*. The National Environmental Action Plan outlines measures for improving air quality and the inclusion of deadlines offers the possibility to monitor progress. Air quality plans and programmes as required by the *acquis* need to be prepared.

Waste management is the single biggest problem in the environment sector in Croatia. Not only does the legislative framework need to be aligned with EU requirements and standards, but existing Croatian regulations are not yet being implemented. A waste management plan needs to be adopted. Recovery, recycling and disposal facilities are in scarce supply and fall considerably short of EU standards. Return and collection systems need to be established. Most waste is disposed of in landfills and unauthorised sites outnumber official sites by at least eight to one, while even many official sites do not operate in line with the Waste Law. There are no hazardous waste disposal sites. This sector poses a major challenge for Croatia and will require major efforts to align with the *acquis*.

The existing **water quality** legislation provides a good basis for alignment with the *acquis* although at local level by-laws are often missing. Necessary inventories, action programmes and designation of vulnerable and sensitive areas need to be ensured. Croatia is party to the International Convention for the Protection of the Danube River Basin and is drawing up a River Basin Management Plan. The sewage system serves 40% of the population with only 12% of waste water being treated (less than 5% receives secondary treatment). In order to align with the *acquis* Croatia will have to make significant investments in waste water collection and treatment as well as in drinking water supply.

Nature protection legislation has been updated through a new Nature Protection Act. Currently 10% of the land area is protected, although there are proposals to increase this to a figure nearer the EU average (15-20%) in the future. With 43% of the territory of Croatia being forested and given the high level of biodiversity, the definition of the network of Natura 2000 sites will represent a major challenge. Whilst the legislative framework for nature protection exists, implementation measures, and particularly the management of protected areas, need to be strengthened. In this context, the recent shift of the competence for nature protection from the Ministry of Environment to the Ministry of Culture appears to deviate from common practice in EU Member States. The protection of endangered species outside protected areas is not currently ensured. The Convention on International Trade in

Endangered Species of Wild Fauna and Flora (CITES) entered into force in 2000. Croatia has cooperated with the Visegrád countries in building national ecological networks.

Regarding **industrial pollution and risk management** there is no system of integrated pollution prevention and control (IPPC). Although air pollution levels in general have fallen in recent times, Croatia would currently be unable to meet the EU emission limits required for large combustion plants and needs to elaborate measures to comply with national emission ceilings. Whilst a legal obligation exists for operators of industrial sites to establish contingency plans, it is unclear to what extent they have been put into effect. Croatia has ratified the UNECE Industrial Accidents Convention.

For **chemicals and genetically modified organisms (GMOs)** it remains to be seen whether the new system restricting GMO use is compatible with the *acquis* on the free movement of goods. Legislation concerning chemical substances is incomplete, there is no register of chemicals on the market and identification of “new” chemicals is not a current requirement. Major efforts will therefore be needed to align with the *acquis* in the chemicals sector. Legislation concerning biotechnology is not yet in place.

The issue of **noise** is dealt with in the National Environmental Strategy and National Environmental Action Plan and legislation has been developed to align with the *acquis*. However the deadlines for specific actions under the Action Plan have been postponed for up to four years.

Regarding **nuclear safety and radiation protection**, Croatia has established a legal framework for different aspects concerning the basic safety standards, medical exposure and emergency preparedness. However, the transposition of the directives laying down the basic safety standards and on health protection in relation to medical exposure remains to be completed and further developed. The *acquis* concerning the operational protection of outside workers, on informing the public in case of radiological emergency, and on the control of shipments of radioactive waste still has to be transposed. The Ministry of Economy is responsible for nuclear safety, the licensing of nuclear facilities including fuel and waste treatment facilities, and implementation of nuclear safeguards. Currently, Croatia operates two storage facilities for used radiation sources and low level waste. The Act on Nuclear Safety, adopted in October 2003, provides for the establishment of a State Institute for Nuclear Safety. Due to the lack of administrative capacity, the direct implementation of Articles 33 to 37 of the Euratom Treaty and of the arrangements for emergency preparedness would pose significant problems. Croatia therefore needs to establish appropriate regulatory bodies, competent radiation protection authorities and special independent advisory committees.

Conclusion

The basic elements of a legislative framework are in place to enable Croatia to pursue alignment with the *acquis*, although a significant increase in the priority given to environmental protection is necessary. This will require enhanced planning and preparation of financing strategies. At present, the various strategies give prominence to environmental protection, but they need to translate into practical measures and environmental aspects need to be taken into account in other sectors. There are serious weaknesses in implementation and enforcement that need to be addressed before the *acquis* can be effectively applied.

Overall, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the field of environment in the

medium term. However, effective compliance with a number of pieces of Community legislation requiring a sustained high level of investment and considerable administrative effort (e.g. waste management, waste water treatment and drinking water) could be achieved only in the long term and will require a significant increase in environmental investment.

Chapter 23: Consumer and health protection

The *acquis* covers protection of the economic interests of consumers (concerning misleading and comparative advertising, price indication, consumer credit, unfair contract terms, distance and doorstep selling, package travel, timeshare, injunctions for the protection of consumers' interests, certain aspects of the sale of consumer goods and associated guarantees and distance marketing of consumer financial services) as well as the general safety of goods (liability for defective products, dangerous imitations and general product safety). EU Member States need to effectively enforce the *acquis* through appropriate judicial and out-of-court dispute resolution mechanisms as well as administrative systems, including market surveillance and a role for consumer organisations.

Croatia has set up a basic legal framework for consumer protection, in particular through the Consumer Protection Act. The main structures to administer consumer protection are also in place. A biannual National Consumer Protection Programme defines priority tasks for Croatia in this area. The Ministry of Economy is the competent authority in this field and a Consumer Protection Council has been established. Market surveillance is largely delegated to the State Inspectorate.

With regards to **safety related measures**, alignment to the principles of the EU Directive on general product safety was sought by adopting the General Product Safety Act in September 2003, which will be complemented by an Ordinance on Mutual Provision of Information. The Croatian legal framework on liability for defective products includes also the principle of objective liability, definition of damage, exemption from liability and burden of proof. It is based on the Croatian Obligations Act. This currently diverges from the *acquis* in several respects and will need to be amended.

Concerning **non-safety related measures**, a Consumer Protection Act, adopted in 2003, aims at transposing EU directives on misleading and comparative advertising, on contracts negotiated away from business premises, on consumer credit, on unfair terms in consumer contracts, on timesharing, on distance contracts and on the indication of the prices of products. The Tourist Trade Act and Obligations Act are partially in line with EU directive on package travel, package holidays and package tours and will need to be amended. Croatia's legislation does not cover EU directives on injunctions for the protection of consumers' interests, on certain aspects of the sale of consumer goods and associated guarantees and on the distance marketing of consumer financial services. Further alignment with the *acquis* is therefore needed on these issues.

In the area of **market surveillance**, the current system, based on pre-market approval, is far from EU requirements. The State Inspectorate is responsible for enforcing market surveillance legislation, in co-operation with other public institutions. Basic provisions are in force on methodology for risk-assessment, product danger notification and co-operation with producers and distributors. Specific market surveillance activities are carried out for certain product categories. However, for a number of other products, market surveillance is missing due to lack of standards, insufficient funding for testing or lack of legal competence of the State Inspectorate. Only an exchange of information at Government level takes place between

Croatia and other countries. Croatia would benefit from becoming a member of the Transitional System for Rapid Exchange of Information on Dangerous Product (TRAPEX).

Two main **consumer organisations** exist in Croatia, but their activities are largely concentrated in the area of Zagreb. Another smaller consumer association exists in Osijek. From 2004, their public funding will be increased. According to the Consumer Protection Act, consumer associations may join the Union of Consumer Protection Associations, a legal entity, which is entitled, *inter alia*, to provide opinions on draft pieces of legislation relevant to consumers and to represent consumer interests in parliamentary discussions. Consumer organisations need to be supported to enhance their role in building up and implementing Croatian consumer policy. The Government should continue its work for the development of an independent, representative and effective consumer movement in Croatia.

No specific legislation is directed to facilitate consumers' access to justice. The Civil Code rules apply. A specific system for alternative resolution of consumer disputes, in line with the relevant Commission recommendations, has not been developed yet. Consumer associations are entitled to initiate proceedings before the competent court against unlawful business practice and misleading advertising, but the weakness of Croatia's judicial system constitutes an obstacle to effective enforcement.

With regard to consumer information and education, Croatia does not have any such programmes in place, although it plans to develop one in the coming years. Actions in this field should be significantly strengthened.

Conclusion

Croatia will have to make further efforts to align its legislation with the *acquis* in this area and to effectively implement and enforce it in the medium term. In particular, these efforts should be directed to product liability and non-safety related measures and to put in place a market surveillance system, which would comply with EU requirements. Reinforcing consumer organisations and promoting the development of an independent and representative consumer movement also requires particular attention, together with the promotion of information and education activities to consumers.

Chapter 24: Co-operation in the field of justice and home affairs

EU policies in the area of justice and home affairs aim to maintain and further develop the Union as an area of freedom, security and justice. On issues such as border control, visas, migration, asylum, drug trafficking and money laundering, combating organised crime, the fight against terrorism, fraud and corruption, police and judicial co-operation, customs co-operation, data protection and the mutual recognition of court judgements, as well as human rights legal instruments, Member States need to be equipped to ensure they achieve adequate and acceptable standards of implementation. Administrative capacity must be up to these standards by the date of accession. Furthermore, an independent, reliable, and efficient judiciary and police organisation are also of paramount importance. The most developed part of this chapter concerns the Schengen *acquis*, which entails the lifting of internal border controls in the EU. However, substantial parts of this *acquis* do not apply upon accession of a new Member State, but only later, after a separate Council Decision.

The *Stabilisation and Association Agreement* foresees intensive cooperation between Croatia and the EU on issues such as visa, border control, asylum, readmission of illegal migrants,

money laundering, organised and drug-related crime, and the improvement of the effectiveness of Croatia's judiciary.

In the field of **data protection**, a new Act on the Protection of Personal Data has been in force in Croatia since June 2003. The Act regulates the protection of personal data on natural persons, as well as the supervision of collection, processing and use of personal data. Croatia has signed but not yet ratified the 1981 Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data. Alignment with the Council of Europe recommendation on the use of police data is under development. The establishment of an Agency for the Protection of Personal Data is foreseen (*see also Chapter 3 – Freedom to provide services*).

Significant developments have taken place in Croatia in the field of **visa policy**. Conformity with EU visa obligations and EU visa-free travel is at a relatively advanced stage. A new Law on Foreigners replaced the previous Act on the Movement and Stay of Foreigners in January 2004. Particular attention needs to be paid to its implementing measures.

An IT system is gradually being established to link Croatia's diplomatic missions to the national visa register (IKOS) at the Ministry of Interior. The development of this system needs to be continued and training of staff made a priority.

Although Croatia is undertaking efforts to modernise and transform its system of **border management**, major challenges still lie ahead. The legislative framework is not yet complete, particularly regarding the creation of an integrated border management strategy. The new State Border Protection Act entered into force in November 2003 but further development of implementing measures will be needed. Croatia also needs to implement the commitments undertaken in this area in the framework of the EU-Western Balkans Forum as defined at the JHA ministerial meeting of November 2003.

The Border Directorate of the Ministry of Interior started to function as a separate unit of the Police only in July 2002, while the border police are still operating as part of the general police at the regional level. As a consequence of the on-going reorganisation, it is not clear how many officers devote their working time primarily to border management. However, their numbers are not yet sufficient, particularly considering that parts of Croatia's land border may become part of the EU's external border in future. Recruitment and training of staff, improvement of working methods (risk analysis capabilities in particular) and modernisation of equipment are urgent matters. In this context, specialised training for border officers at the Police Academy should be strengthened. In addition, co-operation between the various authorities involved in border management needs to be further improved.

The available technical equipment and infrastructure are not yet adequate for effective surveillance of the green border (3,332 km) or the blue border, and substantial investments need to be made. The border police use the central information system of the police, which does not, however, meet the needs of border management and will have to be adapted.

The legal basis for co-operation with neighbouring countries is in place and emphasis should now be put on adequate implementation. In particular, there is ample scope for unauthorised border crossing along the border with Bosnia and Herzegovina, where a large number of cross-border roads and paths remain almost uncontrolled. These crossings will need to be properly controlled to prevent illegal border crossings.

Regarding **migration**, legislation on residence permits, family reunification and related issues is in place. A new Act on Foreigners replaced earlier legislation and is being applied as of January 2004. In the first six months of 2003 there were 34,279 foreigners with permanent residence in Croatia, 10,038 with extended temporary residence, and 1197 with business visas. A large proportion of these were from neighbouring countries. No specific measures exist for the integration of third country nationals, but they enjoy the same basic rights as Croatian citizens.

Croatia is still mainly considered a transit country for **illegal migrants** en route to the Schengen area, rather than a country of destination. In the first nine months of 2003, 2,915 persons, mainly from neighbouring countries, were apprehended while trying to cross the border illegally. Compared with previous years the trend has been declining, which can be attributed to the general stabilisation of the region. Readmission agreements have been signed with 24 countries.

The right to **asylum** is guaranteed by the Constitution. However, currently there is no provision for accelerated procedures, and the concept of 'safe country of origin' is not applied. A new Asylum Act was adopted in July 2003 and is supposed to enter into force from July 2004. The act should strengthen the appeal system and introduce provisions covering temporary protection, 'safe third country', 'manifestly unfounded claims', reception conditions and the integration of refugees. The new act should also be harmonised with the 1951 Convention and the 1967 Protocol on the Status of Refugees and the relevant recommendations and Resolutions of the Council of Europe. A documentation centre for information on the country of origin has not yet been established.

Fingerprints of asylum seekers and illegal migrants are recorded but no electronic database is in place. With a view to possible future participation in Eurodac, the system of taking fingerprints needs to be revised and modernised. Further adjustment of legislation will be required in order to comply fully with the criteria and mechanisms for determining the responsible Member State (Dublin II).

214 persons submitted asylum applications in Croatia between 2000 and summer 2003. So far, all decisions on asylum applications in Croatia have been negative. Current arrangements for a temporary reception centre are unsatisfactory. An Asylum Reception Centre needs to be established, but there has been no clear decision on its location or on the allocation of funding for staffing, running costs and maintenance. In addition, interagency co-ordination structures need to be strengthened and co-operation with international organisations such as UNHCR should be improved.

In the field of **police co-operation**, a new Police Act entered into force in January 2001. On this basis the police have been demilitarised and reforms are on-going. The new legislation provides for clear tasks and responsibilities, but the principle of crime prevention needs to be further elaborated. Equipment and infrastructure need to be improved and an integrated computer-based criminal intelligence system has to be established.

The State Attorney has authority over the criminal police. All investigative activities and other measures limiting citizens' rights have to be agreed with the judicial authorities. The limited investigative powers of other services such as the customs and tax authorities require these services to have close co-operation with the police. This co-operation needs to be further developed and strengthened.

Croatia has police cooperation agreements in place with other countries from the region (in particular, Bosnia and Herzegovina, Serbia and Montenegro, Hungary, Slovenia and Italy). Cooperation and exchange of information has been improving in recent years. In order to be able to conclude the envisaged co-operation agreement with Europol, a satisfactory level of protection of personal data will be necessary.

As regards **organised crime**, Croatia is an important transit country on the Balkan route to Western Europe for trafficking in human beings as well as for smuggling of arms, drugs and stolen cars. Croatia has signed and ratified the 2000 UN Convention on Transnational Organised Crime and the related Protocols on trafficking in human beings and the smuggling of migrants. The Protocol against the Illicit Manufacturing of and Trafficking in Firearms still remains to be signed. Croatia has also ratified the 2001 Council of Europe Convention on Cybercrime. Croatia needs to implement the commitments undertaken in this area in the framework of the EU-Western Balkans Forum as defined at the JHA ministerial meeting of November 2003. Furthermore various amendments to the Criminal Code are still required in order to reach full alignment with EU, Council of Europe and OSCE requirements.

At national level the Office for the Prevention of Corruption and Organised Crime (USKOK) is the main body for tackling the forms of crime mentioned above, including terrorism. However, both the administrative and operational capacities of the Office are still limited and not all the necessary staff have been recruited. Co-ordination with other agencies needs to be improved.

Finally, a more strategic approach to the fight against organised crime should be developed. Action is also required in order to combat illicit manufacturing and trafficking in firearms.

A basic legal framework for combating terrorism is in place. Croatia has ratified various international instruments on the **fight against terrorism**, such as the 1977 European Convention on the Suppression of Terrorism. The 2003 Protocol amending the Convention has been signed. However, the UN Convention for the Suppression of the Financing of Terrorism (1999) still remains to be signed.

Concerning the **fight against fraud and corruption**, Croatia has signed and ratified the Council of Europe's Criminal and Civil Law Conventions on Corruption. Its national legislation has been partly aligned with the provisions of the 1995 Convention on the Protection of the Communities' Financial Interests and its protocols. Further improvements are needed regarding the definition of fraud (both expenditure and revenue), active and passive corruption, criminal liability of heads of businesses and liability of legal persons. At the enforcement level, more attention should be given to the effective prosecution of corruption cases. Action plans to prevent and combat corruption in the relevant law enforcement agencies (border police, police, customs, judiciary) need to be developed.

As regards **protection of the euro** against counterfeiting, Croatia is a member of the 1929 International Convention on the Suppression of Counterfeiting. Its provisions have been incorporated into Croatian law, primarily the Criminal Code, which covers the offence of counterfeiting of foreign currencies including the euro and seems to be generally in line with the *acquis*. (See also Chapter 11 – EMU.)

Croatia is a transit country for **drug** trafficking (mainly heroin) on the Balkan route. Drug consumption within the country as well as detected and reported drug law offences are increasing. Croatia is a signatory to the main UN drug conventions. The Criminal Procedure Act, the Criminal Code and the Act on Combating Drug Abuse comprise the primary national

legislative framework for tackling the supply of drugs. The National Programme on Combating Drug Abuse for 2003 provides the basis for tackling the drugs problem in detail and defines the state bodies with responsibility to adopt specific programmes in order to define concrete actions in each particular field.

More emphasis should be put on improving co-operation and co-ordination among the various law enforcement agencies involved in the fight against drugs. Furthermore the law enforcement services often lack the relevant technical equipment. The majority of drug addicts are not included in any drug treatment programme. A national information network should be created and the Office for Combating Drugs Abuse should be prepared for its future role as National Focal Point and for potential co-operation with the European Monitoring Centre for Drugs and Drug Addiction (EMCDDA).

Croatia has been making efforts to fight **money laundering**. A basic legal framework in this area has been adopted and developed during the past years. Croatia has ratified the European Convention on Money Laundering, Search, Seizure and Confiscation of the Proceeds of Crime and has begun to incorporate international conventions and EU standards into its national legislation.

The Office for the Prevention of Money Laundering, established within the Ministry of Finance in compliance with the Money Laundering Prevention Act, functions as an autonomous and independent financial intelligence unit (FIU). It gathers and analyses information on suspicious movements of money and reports this to the police and the prosecutor. However, enforcement in this area remains weak. Only one money laundering case has so far led to a conviction. Thus, the FIU needs to be further strengthened and cooperation with the police, the State Attorney's office and the judiciary needs to become more effective. (*See also Chapter 4 – Free movement of capital*).

Efficient **customs co-operation** requires an adequate level of infrastructure and equipment, including computerisation and investigation resources, and the establishment of an efficient customs organisation with a sufficient number of qualified and motivated staff showing a high degree of integrity.

There is room for improvement in the co-operation between the police, customs, and other border agencies. No Memorandum of Understanding (MoU) has been concluded yet between them. It would be useful for Croatia to put in place a programme of MoUs with business organisations and between customs and the police to combat in particular drug trafficking. Consideration should also be given to legislative changes in accordance with the relevant EU conventions (Naples II and Information Technology), to the creation of a special investigation service within the customs administration and to the establishment of a customs training system.

Regarding **judicial cooperation in civil and criminal matters**, recognition and enforcement of foreign judicial decisions is incorporated in the Conflict of Laws Act, and the general system for civil and commercial matters is similar to that laid down in EU legislation. Rules on applicable law, procedures relating to payment orders, decisions on personal status matters, and international insolvency proceedings are also broadly in line with Community legislation and principles. Bilateral conventions are in place with a number of neighbouring countries.

Several key conventions have been or are in the process of being ratified, including the 1972 European Convention on the Transfer of Proceedings in Criminal Matters, the 1959 Convention on Mutual Legal Assistance in Criminal Matters, the 1957 European Convention

on Extradition and the 1980 Hague Convention on the Civil Aspects of International Child Abduction. Croatia is not a party to the 1965 Hague Convention on the Service Abroad of Judicial and Extra-Judicial Documents in Civil and Commercial Matters and current methods differ significantly from those set out by the EU. Furthermore it is not a party to the 1970 Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters. Legislation providing for the compensation of victims of terrorist acts and public demonstrations should be extended to include victims of all crime. Improvements should be made to the training of judges in areas such as international co-operation and new investigation techniques.

Conclusion

Croatia has made efforts to align its legislation with the *acquis* in the field of justice and home affairs and has started to make progress with the implementation of reforms in institutions such as the police, the border police and the financial intelligence unit. However, considerable work remains to be done to bring the legislation further in line with the *acquis* and to transform the law enforcement agencies into effective institutions capable of addressing the tasks they face. Furthermore, considerable investments will be necessary in equipment and infrastructure as well as in strengthening of administrative capacity. The geographical position of Croatia at a crossroads of migratory flows poses a particular challenge.

Overall, Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the area of justice and home affairs in the medium term.

Chapter 25: Customs union

The Customs union *acquis* consists almost exclusively of legislation which is directly binding on the Member States and does not require transposition into national law. It includes the Community's Customs Code and its implementing provisions; the Combined Nomenclature, Common Customs Tariff and provisions on tariff classification, customs duty relief, duty suspensions and certain tariff quotas; and other provisions such as those on customs control of counterfeit and pirated goods, drugs precursors and cultural goods and on mutual administrative assistance in customs matters as well as Community agreements in the areas concerned, including transit. Member States must ensure that the necessary enforcement capacities, including links to the relevant EC computerised customs systems, are in place.

The *Stabilisation and Association Agreement / Interim Agreement on trade and trade-related matters* cover the establishment of a free trade area with the Community and the immediate or progressive removal of customs duties on a very wide range of products. They also contain rules of origin which have to be respected in order to benefit from the trade preferences provided.

The **Customs Act of Croatia** and its implementing provisions are modelled on the Community customs code and implementing provisions. They include customs procedures and provisions such as Binding Tariff Information, Binding Origin Information, customs valuation, rules of origin, customs procedures with economic impact and free zones. There are 14 free zones in Croatia. They will require adaptations to come into line with the *acquis* (*see also Chapters 6 and 10 - Competition and Taxation*). Simplified procedures including the authorisation of operators based on appropriate audit systems would need to be developed further.

Croatia regularly updates its customs legislation to take into account the amendments to the EC customs code and implementing provisions. However, amendments made to the EC customs code in 2000 have not yet been transposed; these cover *inter alia* provisions on customs procedures with economic impact, free zones and free warehouses, the use of electronic declaration, and incurrence of a customs debt. Major efforts will be needed to adapt the Croatian transit procedure to the new computerised transit system (NCTS) requirements. Provisions on customs control of counterfeit and pirated goods, allowing customs to intervene both upon request and *ex officio* are already applicable. Customs control systems for import and export of cultural goods and precursors are already in force. Some of the customs clearance fees currently applied under the Administrative Fees Act, the Administrative Fees Tariff and the Customs Tariff Act appear to be contrary to the *acquis* and will have to be removed.

Croatia applies **preferential rules of origin** in the framework of its existing Free Trade Agreements, including the Stabilisation and Association Agreement / Interim Agreement on trade and trade-related matters with the Community. Specific problems have occurred recently in relation to certificates of preferential origin for sugar which led the European Commission to issue a formal notice to importers of this product. This case exposed important weaknesses in the Croatian systems of management and control of certificates of preferential origin. Subsequently, the Croatian administration identified improvements for introduction into this aspect of customs control. It will be important to ensure that Croatia has fully implemented the measures necessary to prevent a recurrence of this kind of problem. In this respect, effective control of rules of origin in Croatia will be essential.

As from 2002, the **Croatian Customs Tariff** is based on the Combined Nomenclature, as required by the provisions of the Interim Agreement. An electronic version of the Tariff is also available to the public via Internet. It will constitute a good basis for the setting up of an integrated tariff compatible with the Integrated Tariff of the Community (TARIC). Croatia does not operate tariff ceilings. Croatia does not apply a General System of Preferences.

With the support of the technical assistance provided by the Community, Croatia is building up the **administrative and operational capacity** of its customs service. A Customs Service Act is in place, governing the Croatian Customs Administration. The legal conditions and organisational structure of the Croatian Customs Service will have to be reviewed to make them fully compatible with EU requirements and standards. In particular, the Customs administration should be granted more flexibility to allocate budgetary and human resources.

A training system should be developed to cover the whole range of customs issues, including those which are accession related, and should be available to all staff. Croatia would need on accession to dismantle customs controls at the borders with EU member states. The resources needed for the reinforcement of the border posts along its frontiers with non-EU member states should be taken into account in its strategic planning. The internal audit function should be improved. Internal communication will have to be enhanced to guarantee a uniform implementation of the customs legislation throughout the country. Relations with end users, especially in terms of communication, still need further improvement. The customs service has an Internet web page solely in the Croatian language.

A Code of Ethics for the customs service is still lacking and will need to be developed and implemented. Efforts to establish customs controls on the basis of risk assessment to speed up customs procedures are being made. A new risk analysis department in charge of building a uniform risk analysis system is being set up. The department needs to become fully operational. Croatia already applies post-clearance controls but these will have to be

reviewed. The three existing Customs laboratories will have to be upgraded to make them compatible with EU requirements.

The use of information technology (IT) within Croatian Customs seems to be widespread via a stable network. Additionally, a trader connection to the Customs Declaration Processing System (CDPS) is operational. The IT applications in Croatia for transit, tariff, inward processing, (binding) tariff information and import quotas appear to be operational. Compatibility with the EC customs computerised systems will have to be ensured in order to guarantee interconnectivity in the event of accession.

Conclusion

Croatia has started to make efforts to prepare to fulfil the responsibilities of an EU customs administration and to assume the responsibilities necessary for the protection and control of the EU's external borders. Croatia will have to make further efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term. Especially its administrative capacity needs to be assessed. Particular attention needs to be given to the modernisation and strengthening of the customs administration by providing, amongst others, sufficient budgetary, IT and human resources, as well as further training.

Chapter 26: External relations

The *acquis* in this field consists mainly of directly binding EU legislation which does not require transposition into national law. This EU legislation results from the Community's multilateral and bilateral commercial commitments, as well as from a number of autonomous preferential trade measures. In the area of humanitarian aid and development policy, an applicant country will need to comply with EU legislation and international commitments in this field and ensure the capacity to participate in the EU's development and humanitarian policies.

The *Stabilisation and Association Agreement / Interim Agreement on trade and trade-related matters* include provisions in several areas requiring the parties to act in accordance with the principles of the WTO or of other relevant international obligations.

Croatia has been a member of the **World Trade Organisation** since 30 November 2000. It undertook ambitious commitments upon accession, which it is gradually implementing. Croatia has not yet started negotiations to accede to the WTO Government Procurement Agreement. Upon accession to the EU, Croatia would have to apply all the obligations of the multilateral and plurilateral WTO agreements to which the Community is a party. In particular, Croatia would have to apply the Community's Common Customs Tariff and the external provisions of the Common Agricultural Policy. The agreed transitional period for the implementation by Croatia of its WTO schedule of concessions and commitments on goods ends by 2007. By then, Croatia will feature simple average duties on industrial goods of approximately 5.3 % and on agricultural goods of 15.5%. The equivalent current levels for the EU stand at 3.6% on industrial goods, 12.4% on fishery products and 16.2% on agricultural goods.

Upon accession to the EU, Croatia would be bound by the Community's **common commercial policy** and the Community's various preferential trade agreements. It would also become party to the European Economic Area. Furthermore, Croatia would have to apply the autonomous preferential trade regime that the Community grants to certain third countries, for

example the Generalised System of Preferences. Conversely, Croatia would have to terminate all its preferential trade agreements with third countries and bring all other agreements, including non-preferential trade agreements, into conformity with the obligations of EU membership. Currently, in addition to the Stabilisation and Association Agreement / Interim Agreement with the Community, Croatia has free trade agreements in force with Albania, Bosnia-Herzegovina, the Former Yugoslav Republic of Macedonia, Switzerland, Liechtenstein, Norway, Iceland and Turkey. Croatia had concluded Free trade Agreements with six of the ten acceding countries (Slovenia, Hungary, Poland, Czech Republic, Slovak Republic and Lithuania) which will lapse upon accession of these countries to the EU on 1 May 2004. Croatia is a member of CEFTA and after the 2004 EU enlargement will maintain its preferential CEFTA arrangements with Bulgaria and Romania. Finally, a free trade agreement signed with Serbia and Montenegro has yet to enter into force.

In the area of services, Croatia's commitments under **GATS** are not entirely in line with those of the Community. Croatia should ensure that, upon its accession, its multilateral commitments under GATS are as consistent as possible with those of the Community. To this end, Croatia should closely co-operate and co-ordinate with the European Commission, mainly with regard to the Doha Development Agenda negotiations.

Croatia is in the process of adopting implementing legislation in the field of **trade defence instruments**. Upon accession, it would have to repeal any national legislation and measures in this field, as Community legislation will become directly applicable on its territory.

Croatia is currently running both **export credit insurance and financing programmes**. On accession, Croatia should ensure that its short-term export credit insurance system is in line with Community competition rules. As far as medium and long-term export credits are concerned, rules will have to be further aligned so as to be in full conformity with Community legislation and international obligations.

Arms exports are currently controlled. In addition, Croatia is drafting national legislation to subject dual use items to export control. Upon accession, Croatia would have to abide fully by relevant EU legislation in this field.

With regard to **administrative capacity**, participation in the EU trade decision-making mechanisms and implementation and enforcement of the *acquis* will require strengthening of the Trade Policy and Foreign Economic Relations Division of the Ministry of Economy.

Croatia has concluded **bilateral investment treaties** with 50 countries. Before its accession to the EU, Croatia would have to ensure that the content of these agreements is fully compatible with its EU membership obligations and the EU *acquis*. To this aim, it should ensure that the necessary procedures to either modify or denounce the agreements, where applicable, are taken early enough to ensure that conformity with EU obligations is in place by the date of accession. In doing so, Croatia should consider the long period of initial duration of certain agreements, which can run in some cases for 20 years.

As regards **development policy and humanitarian aid initiatives**, Croatia has no legal framework on development co-operation. Apart from a set of fragmented projects shared among different Ministries, the only such assistance appears to consist of targeted humanitarian aid projects on the occasion of humanitarian catastrophes. The humanitarian assistance from the state commodity reserve amounted to HRK 5.1 million (€671,000) in 2000 and to HRK 433,000 (€58,000) in 2001.

Croatia does not have a specific structure within a Ministry or an Agency in charge of development policy and no overall co-ordination concerning development-related activities appears to take place among the various ministries.

At this stage, Croatia would not be in a position to play its part in supporting the objectives and instruments, or to participate in the further development as well as the implementation, of the EU's development policy.

Conclusion

With regard to external relations, Croatia should be able to meet Community requirements in this field in the medium term, provided the institutional capacity to effectively implement and enforce the *acquis* is strengthened. In order to smooth its preparations for membership Croatia should ensure that its actions and commitments within international organisations and agreements respect both the Stabilisation and Association Agreement as well as future obligations resulting from the *acquis*.

Chapter 27: Common foreign and security policy

The *acquis* related to the common foreign and security policy (CFSP) is based on legal acts under the second and, indirectly the first, pillar including legally binding international agreements. It is also based on political declarations and agreements to conduct political dialogue in the framework of CFSP, to align with EU statements, and to apply sanctions and restrictive measures here required.

Pending the entry into force of the Stabilisation and Association Agreement, present rules for the regular **political dialogue** between the European Community and its Member States and the Republic of Croatia are set out in the joint declaration of 29 October 2001. Political dialogue meetings at ministerial level were held regularly and proceeded smoothly. During these meetings Croatia has shown a keen interest to continue active participation in political dialogue with the EU.

Over the last two years, Croatia has unilaterally declared its association with several CFSP common positions and declarations of the Union concerning inter alia the fight against terrorism. In the meantime, under the Thessaloniki Agenda for the Western Balkans, the EU regularly invites Croatia to align itself to certain EU demarches, declarations and common positions on CFSP. Croatia has supported the establishment of the International Criminal Court, and ratified the Rome Statute in 2001. It has not signed a bilateral agreement with the USA concerning the non-surrender of certain persons to the ICC.

In May 2002, Croatia subscribed to the EU Code of Conduct on Arms Exports. Croatia is party to most of the existing international regimes for the **non-proliferation** of weapons of mass destruction. It has not yet joined the Wassenaar Arrangement, the Australia Group, and the Missile Technology Control Regime but has indicated its intention to do so. Croatia takes part in the preparatory work for the International Code of Conduct against Ballistic Missile Proliferation. However, Croatia needs to strengthen the relevant law enforcement agencies in charge of the internal controls necessary for the full implementation of international non-proliferation regimes and relevant EU standards, including those pertaining to the control of trade both in small and light weapons and dual use goods.

Concerning relations with neighbouring countries, some territorial disputes remain unresolved (*see chapter on Political Criteria – Bilateral Relations*). Croatia is a member of the United Nations, the OSCE, and the Council of Europe and a member or observer in many other international organisations and agreements and an active participant in several regional and sub-regional initiatives (*see chapter on Political Criteria – Multilateral Relations*). However, it has not yet acceded to all relevant UN conventions, e.g. in the field of the fight against terrorism.

Croatia has begun to take part in international peace-keeping efforts (ISAF) and has dispatched military observers to certain UN missions. It is in the process of designating forces for further peace-keeping operations and is preparing the necessary restructuring measures. It has declared its willingness to support, participate in, and contribute to European Security and Defence Policy (**ESDP**) civilian and military crisis management operations. However, the necessary resources still need to be allocated.

With regard to **administrative capacity**, Croatia has a rather new diplomatic staff which, despite limited resources, maintains an extended network of diplomatic missions. It has 55 diplomatic representations, 22 consular representations and one embassy bureau abroad and employs some 1,000 staff. In order to be able to work with EU CFSP structures, Croatia would need to establish the necessary functions and mechanisms within the Ministry for Foreign Affairs. Concerning the implementation of sanctions and restrictive measures, it will also need to adjust its administrative capacity to EU standards. While overall administrative capacity will also certainly need to be increased, in due course Croatia should be able to cope with the demands stemming from the Common Foreign and Security Policy.

Conclusion

Croatia has declared that, as a Member State, it will support actively and unreservedly the CFSP so defined, in a spirit of loyalty and mutual solidarity.

The assessment of Croatian foreign and security policy to date leads to the expectation that, provided it takes the necessary legal and administrative measures and makes necessary adjustments, Croatia should be able to fulfil its obligations within CFSP in the medium-term.

Chapter 28: Financial control

The *acquis* under this chapter consists mostly of general, internationally agreed and EU compliant principles of public internal financial control that need to be transposed into the control and audit systems of the entire public sector. In particular, the *acquis* requires the existence of effective and transparent financial management and control systems as well as functionally independent internal audit systems; an independent external audit of the public internal financial control systems in the public sector (Supreme Audit Institution); an appropriate financial control mechanism for EU funds; and the administrative capacity to give effective and equivalent protection to EC financial interests.

As regards **public internal financial control** (PIFC), Croatia has not yet set up a comprehensive control structure based on managerial accountability and functionally independent internal audit. The primary legislation defining the concept of Internal Audit is the Budget Act. Ex-ante control is performed through the implementation regulations of the State Treasury System (Single Treasury Account). The current situation is characterised by a certain compartmentalisation of responsibilities, weaknesses in communication and reporting,

lack of obligatory ex-ante financial control inside income and spending centres and by the lack of harmonised legislation relating to control and audit competencies. The Directorate for Internal Audit and Control within the Ministry of Finance is responsible for the development and the harmonisation of PIFC concepts. The establishment of functionally independent and operational internal audit units will be the major administrative challenge in this field.

External audit is performed by the State Audit Office (SAO) on the basis of the 1993 State Audit Act. Audits cover all public expenditure from the state budget, state funds as well as from the budgets of local and regional self-government units. The State Audit Act should, but does not yet, foresee the external audit of EU-funds. SAO audits comprise financial audits as well as systems-based and performance audits. The SAO is an autonomous body; however, since its budget is an integrated part of the state budget, efforts are needed to increase its budgetary independence. The administrative capacity of the SAO, in particular in terms of human resources should also be strengthened.

As regards **control over EU funds**, efficient mechanisms for monitoring, controlling and auditing EU-funds will need to be developed. A system to deal with securities, debts and recoveries has not yet been set up.

Croatia is also in an early stage of legislative and administrative preparations with regard to the **protection of the EC's financial interests**. The existing procedures and the division of competencies between the different bodies involved mainly cover criminal-law procedures for the treatment of cases of (suspected) fraud, and to a lesser extent other irregularities. No specific institution or body exists for the investigation and/or treatment of irregularities but several existing bodies have responsibilities in this respect. There will be a need to establish and implement properly effective procedures for the detection, treatment, as well as for the financial and administrative/judicial follow-up of irregularities, and to establish the necessary coordination methods to this end.

Conclusion

Croatia needs to develop general policies and a coherent legislative framework in this field. Administrative capacities, including functionally independent internal audit units in State institutions, have to be established or reinforced and relevant staff trained. The State Audit Office has the legal and organisational basis to develop further into an appropriate external audit body but needs to be strengthened. In the area of control over EU funds, efficient mechanism for monitoring, controlling and auditing of EU funds will need to be developed. In addition, Croatia's administrative capacity to give effective and equivalent protection to the EC's financial interests will need to be ensured.

Provided Croatia makes further efforts to reorganise and strengthen its public internal financial control, external audit and anti-fraud capacities, it should be able to meet EU requirements in this field in the medium term.

Chapter 29: Financial and budgetary provisions

The *acquis* in this field covers the rules concerning the financial resources necessary for the funding of the EU budget ('own resources'). These own resources are made up mainly from contributions from Member States based on traditional own resources from customs and agricultural duties and sugar levies; a resource based on VAT; and a resource based on the level of gross national income (GNI). Member States must ensure the creation of appropriate

administrative capacity to adequately co-ordinate and ensure the correct calculation, collection, payment and control of own resources and reporting to the EU for implementation of the own resources rules. The *acquis* in this area is directly binding and does not require transposition into national law.

Based on the Customs Act, Croatia adopts each year a Customs Tariff Regulation, which is implemented by the Customs Administration. The Administration levies customs duties, VAT upon import and special import duties. Outstanding and recovered debts are kept in separate records. The Ministry of Finance has the overall responsibility for financial and budgetary issues.

National Accounts and GNP/GNI figures are produced using definitions and accounting rules of the European System of Integrated Economic Accounts 95 (ESA 95). National Accounts are not fully adjusted to take into account the non-observed economy.

Conclusion

There are no significant divergences between the Croatian and the EU system concerning the basic principles and institutions in the underlying policy areas linked to the application of the own resources system. If it continues its efforts to align with the relevant *acquis* chapters, in particular customs, taxation, statistics and financial control, Croatia should not have particular difficulties in meeting the requirements of the own resources system in the medium term.

C. SUMMARY AND CONCLUSIONS

Croatia submitted its application for membership of the European Union on 21 February 2003.

In accordance with the provisions of Article 49 of the Treaty, the Commission has, at the request of the Council, prepared an Opinion on Croatia's request for membership.

Croatia is preparing for membership on the basis of the Stabilisation and Association Agreement signed on 29 October 2001 and the Interim Agreement which entered into force in March 2002.

In preparing its Opinion, the Commission has taken into account the "Thessaloniki Agenda for the Western Balkans" adopted by the European Council of June 2003, where the EU stated *"that the pace of further movement of the Western Balkans countries towards the EU lies in their own hands and will depend on each country's performance in implementing reforms, thus respecting the criteria set by the Copenhagen European Council of 1993 and the Stabilisation and Association Process conditionality"*

The Copenhagen European Council of June 1993 stated that those candidate countries of Central and Eastern Europe who wish to do so shall become members of the Union if they meet the following conditions:

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

In assessing progress in these areas, the Commission has taken into account the capacity of Croatia's administrative and legal systems to apply and enforce the *acquis* in practice.

The Commission has also taken into account the Stabilisation and Association Process conditionalities which were defined by the Council on 29 April 1997. These include co-operation with the International Criminal Tribunal for the Former Yugoslavia (ICTY), regional co-operation and other related issues.

The method followed in preparing this Opinion is the same as used in previous Opinions. The Commission has analysed both the present situation and the medium term prospects. In drawing up its recommendation on the opening of the accession negotiations, the Commission has paid particular attention to Croatia's existing capacity to fulfil the political criteria.

1. POLITICAL CRITERIA

Croatia has stable democratic institutions which function properly respecting the limits of their competences and co-operating with each other. The 2000 and 2003 elections were free and fair. The opposition plays a normal part in the operation of the institutions.

There are no major problems over assuring the rule of law and respect for fundamental rights. However, Croatia needs to take measures to ensure that the rights of minorities, in particular of the Serb minority, are fully respected. Croatia should speed up the implementation of the constitutional Law on National Minorities and accelerate efforts to facilitate the return of Serb refugees from Serbia and Bosnia and Herzegovina. Croatia needs to make substantial improvements in the functioning of the judicial system. The effectiveness of the fight against corruption needs further strengthening.

Croatia's cooperation with the International Criminal Tribunal for the Former Yugoslavia has improved significantly in the past months. In April 2004, the Prosecutor stated that Croatia is now cooperating fully with ICTY. Croatia needs to maintain full cooperation and take all necessary steps to ensure that the remaining indictee is located and transferred to ICTY in The Hague. Croatia remains committed to regional co-operation; sustained efforts are needed in this area. In particular to resolve border issues with neighbouring countries in line with international standards for dispute settlement, and issues arising from the unilateral declaration of the protected "Ecological and Fishing Zone" in the Adriatic.

2. ECONOMIC CRITERIA

Croatia can be regarded as a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its reform programme to remove remaining weaknesses.

In Croatia, there is an increasing political consensus on the essentials of economic policies. The Croatian economy has achieved a considerable degree of macroeconomic stability with low inflation. Enhanced economic stability and structural reforms undertaken so far permit the working of market mechanisms. This holds in particular for the liberalisation of prices and trade as well as for privatisation, albeit to a lesser extent. Croatia is characterised by a relatively well educated labour force and good road transport and telecommunication infrastructure. The country has a well developed banking sector and a competitive tourism industry. Croatia's economy is already well integrated with that of the EU.

However, the working of market mechanisms still needs some improvement. In particular, the performance of the judicial sector needs to be enhanced and high administrative burdens as well as incomplete systems of cadastre and land registry need to be addressed. Enterprise restructuring and privatisation has been slower than expected and some large state and formerly socially-owned enterprises still play an important role in the economy. In particular the shipbuilding and agriculture sectors need to be modernised. The necessary reforms of the fiscal and social security systems as well as the public administration are not yet completed and fiscal consolidation needs to be vigorously pursued. Full integration in the single market and the adoption of the *acquis* would, at this stage, cause difficulties for a number of sectors in withstanding the competition within the single market. Addressing the identified weaknesses should contribute to higher investment and growth, thereby enhancing Croatia's competitiveness.

3. CAPACITY TO TAKE ON THE OTHER OBLIGATIONS OF MEMBERSHIP

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

- The obligations set out in the Stabilisation and Association Agreement, 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 ratification process of the Stabilisation and Association Agreement with Croatia has not been completed. Croatia has made progress in applying the Interim Agreement although due attention needs to be paid to the respect of the deadlines set out therein. Croatia has also taken important steps towards complying with future obligations of the Stabilisation and Association Agreement (SAA).

Croatia has made significant efforts to align its legislation with the *acquis*, particularly in areas related to Internal Market and trade. These efforts need to be continued vigorously. Administrative capacity is uneven and enforcement of legislation needs to be improved. Croatia needs to continue legislative alignment while at the same time strengthening administrative and judicial structures that are necessary for the effective implementation and enforcement of the *acquis*.

If it continues its efforts, Croatia should not have major difficulties in applying the *acquis* in the medium term in the following fields: Economic and Monetary Union; Statistics; Industrial policy; Small and medium-sized enterprises; Science and research; Education and training; Culture and audio-visual policy; External relations; Common foreign and security policy; Financial and budgetary provisions.

Croatia will have to make further efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term in the following fields: Free movement of capital; Company law; Fisheries; Transport; Energy; Consumer and health protection; Customs union; Financial control.

Croatia will have to make considerable and sustained efforts to align its legislation with the *acquis* and to effectively implement and enforce it in the medium term in the following fields: Free movement of goods; Free movement of persons; Freedom to provide services; Competition; Agriculture; Taxation; Social policy and employment; Telecommunications and information technologies; Regional policy; Justice and home affairs.

For the environment, very significant efforts will be needed, including substantial investment and strengthening of administrative capacity for the enforcement of legislation. Full compliance with the *acquis* could be achieved only in the long term and would necessitate increased levels of investment.

CONCLUSION

- Croatia is a functioning democracy, with stable institutions guaranteeing the rule of law. There are no major problems regarding the respect of fundamental rights. In April 2004, the ICTY Prosecutor stated that Croatia is now cooperating fully with ICTY. Croatia needs to maintain full cooperation and take all necessary steps to ensure that the remaining indictee is located and transferred to ICTY. Croatia needs to make additional efforts in the

field of minority rights, refugee returns, judiciary reform, regional co-operation and the fight against corruption. On this basis, the Commission confirms that Croatia meets the political criteria set by the Copenhagen European Council in 1993 and the Stabilisation and Association Process conditionalities established by the Council in 1997.

- Croatia can be regarded as a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its reform programme to remove remaining weaknesses.
- 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 its legislation with the *acquis* and ensure its implementation and enforcement. However full compliance with the *acquis* in the field of environment could be achieved only in the long term and would necessitate increased levels of investment.

In the light of these considerations, the Commission recommends that negotiations for accession to the European Union should be opened with Croatia.

To assist Croatia in the preparation of accession negotiations, a comprehensive screening exercise would need to be undertaken. Furthermore, the Commission recommends that the EU develops a pre-accession strategy for Croatia and is preparing the necessary proposals to this effect.

This Opinion is accompanied by a draft European Partnership for Croatia which identifies the priorities which it needs to address in preparing for accession. The Commission will report regularly to the Council on the progress made by Croatia on its preparation for EU membership.

ANNEX I - STATISTICS

If not explicitly stated otherwise, data contained in this annex are collected from the Central Bureau for Statistics (CBS) of Croatia.

The data presented below have been compiled as far as possible using EU definitions and standards, which in some limited cases differ from national practices. This may occasionally give rise to differences between the data presented here and those presented in other chapters of the Opinion, which are generally based on the reply of Croatia to the questionnaires sent in July 2003.

The methodological notes explain the contents and particularities of statistical data presented in this Annex. Data correspond to the information available as of January 2004.

BASIC DATA

	1998	1999	2000	2001	2002
	in 1000				
Population (as of 30th June)	4501.0	4554.0	4381.0	4437,0	4443.2
	in km²				
Total area	56542	56542	56542	56542	56542

2001 population data are based on the census conducted on 31 March 2001.

DEMOGRAPHY

	1998	1999	2000	2001	2002
	per 1000 of population				
Natural growth rate	-1.2	-1.5	-1.5	-1.9	-2.4
Net migration rate (including corrections)	9.8	4.1	5.3	3.8	1.9
	per 1000 live-births				
Infant mortality rate	8.2	7.7	7.4	7.7	7.0
Life expectancy :	at birth				
Males:	...	...	...	71.1	71.2
Females:	...	...	...	78.1	78.3

Age Structure	as % of Total Population				
- people aged under 15	19,9	19,8	19,8	17,0	16,7
- people aged between 15 and 64	67,8	67,9	67,7	66,9	67,2
- people aged 65 or over	12,3	12,4	12,5	15,6	16,1
	in 1000s				
- Immigration, total	51,8	32,9	29,4	24,4	20,4
- Emigration, total	7,6	14,3	6,0	7,5	11,8

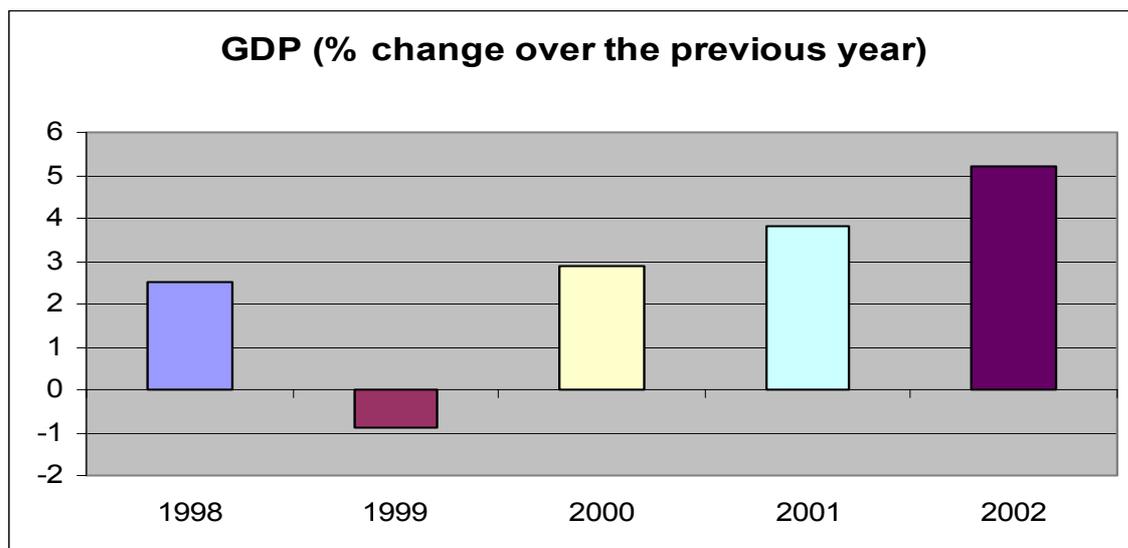
NATIONAL ACCOUNTS

	1998	1999	2000	2001	2002
1000 Mio Kuna					
Gross domestic product at current prices	137.6	141.6	152.5	162.9	176.4
Mio ECU/euro					
Gross domestic product at current prices	19281.4	18543.5	19976.3	21811.5	23820.0
ECU/euro					
Gross domestic product per capita at current prices	4,283.8	4071.9	4501.7	4915.3	5367.9
% change over the previous year					
Gross domestic product at constant prices (nat. current)	2.5	-0.9	2.9	3.8	5.2
Employment growth	0.1	-1.5	-1.7	0.5	0.8
Labour productivity growth	11.02	4.42	9.62	8.01	5.67
in Purchasing Power Standards					
Gross domestic product per capita at current prices	7,575	7,509	8,085	8,618	9,266
% of Gross Value Added b)					
Structure of production					
- Agriculture A;B)	9.4	9.8	9.0	9.1	8.2
- Industry (excluding construction) (C,D,E)	25.0	24.6	24.7	24.3	23.4
- Construction	6.7	5.3	4.6	4.9	5.3
- Services (G-Q)	59.0	60.4	61.9	61.8	63.2
as % of Gross Domestic Product					
Structure of expenditure					
- Final consumption expenditure	85.5	85.4	84.9	83.6	82.1
- household and NPISH	60.1	58.9	60.1	60.0	60.1
- general government	25.4	26.5	24.8	23.6	22.0
- Gross fixed capital formation	23.3	23.3	21.8	22.9	24.8
- Stock variation	0.7	-0.3	-1.6	1.6	2.1
- Exports of goods and services	39.6	40.9	47.1	49.1	45.9
- Imports of goods and services	49.2	49.3	52.3	54.7	54.9

For 2002, the data correspond to the sum of quarterly accounts.

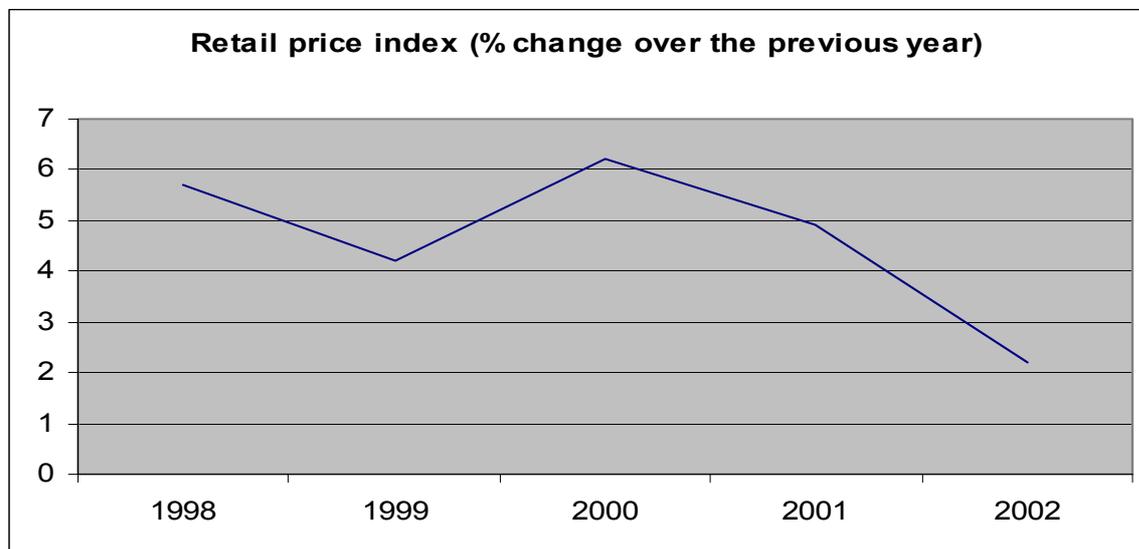
The last official data for GDP by PPP is 8267 \$ for the year 1999. The calculation was made by the OECD and published in their publication "Purchasing Power Parities and Real Expenditure", 1999 benchmark year. The next official data for Croatia will be for the year 2002. PPPs for non EU Countries are only available every three years and intermediate years have to be estimated, usually by the international organizations. In this case, the missing data has been estimated by the CBS.

Stock variation for 2002 is a preliminary estimation. The final figure will be available when the calculation of the GDP for 2002 will be completed.



INFLATION RATE

	1998	1999	2000	2001	2002
	% change over the previous year				
Retail price index	5.7	4.2	6.2	4.9	2.2



BALANCE OF PAYMENTS

	1998	1999	2000	2001	2002
	Mio ECU/euro				
-Current account	-1,295	-1313	-510	-810	-1778
-Trade balance	-3,636	-3112	-3495	-4596	-5570
Exports of goods	4,082	4139	4965	5314	5283
Imports of goods	-7,718	-7251	-8461	-9910	-10852
-Net services	1,861	1538	2461	3255	3204
-Net income	-150	-333	-435	-547	-570
-Net current transfers	630	594	959	1079	1157
-of which : government transfers	-8	-123	24	64	39
- FDI (net) inflows	750	1337	1147	1566	384

Due to limitations of data source, the CNB compiles Croatian BOP in USD and Croatian Kuna. The figures provided in this table result from the conversion of Kuna denominated BOP into euro.

PUBLIC FINANCE

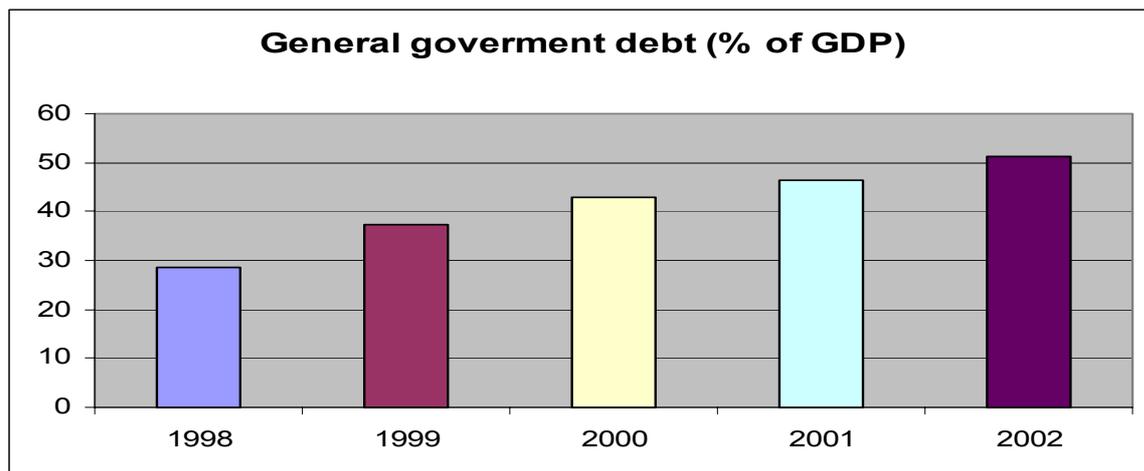
	1998	1999	2000	2001	2002
	in % of Gross Domestic Product				
General government deficit/surplus	-0.92	-6.58	-6.96	-5.49	-2.96
General government debt	28.50	37.50	42.80	46.24	51.20

Public expenditures	as % of Gross Domestic Product				
Health	5,7	5,7	5,5	5,0	4,8
Social protection	14,5	16,5	16,4	19,3	21,2
Education	3,8	4,2	4,5	4,2	4,3

The data on general government deficit/surplus includes consolidated general government, the GFS 1986 methodology is used, with the only exception of the data on privatization revenues, which is excluded from the revenue and reclassified to the financing of balance.

The data on general government debt for the year 2002 includes the data for the central government, local governments, Croatian bank for reconstruction and development, and guarantees. The data for earlier years is not fully comparable with the data for 2002 because of methodological differences. The reconstruction of the data for those years is currently under way.

The data on public expenditure in 2002 is a preliminary estimation; the final figure will be available when final annual GDP for 2002 is finished.



FINANCIAL INDICATORS

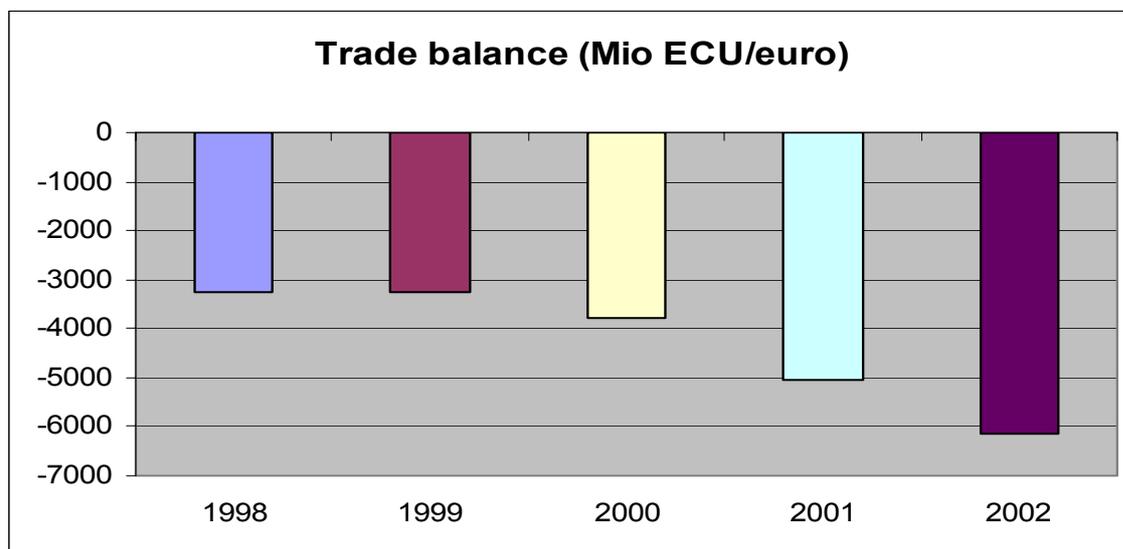
	1998	1999	2000	2001	2002
	in % of Gross Domestic Product				
Gross foreign debt of the whole economy	44.8	50.1	60.0	57.0	68.6
	as % of exports				
Gross foreign debt of the whole economy	113.3	122.9	127.5	117.5	145.7
Monetary aggregates	1000 Mio ECU /euro				
- M1	1.8	1.8	2.4	3.2	4.1
- M2					
- M3					
-M4	7.8	7.4	9.6	14.4	15.6
Total credit	9.1	8.6	9.5	11.9	15.1
Average short-term interest rates	% per annum				
- Day-to-day money rate	10.9	10.1	3.0	2.3	1.7
- Lending rate	16.1	13.5	10.5	9.5	10.9
- Deposit rate	4.1	4.3	3.4	2.8	1.6
ECU/EUR exchange rates	(Kuna per euro/ECU)				
- Average of period	7.1	7.6	7.6	7.5	7.4
- End of period	7.3	7.7	7.6	7.4	7.4
	1995=100				
- Effective exchange rate index	111.9	122.6	126.0	123.0	118.6
Reserve assets	Mio ECU/euro				
-Reserve assets (including gold)	2,400	3,013	3,783	5,334	5,651
-Reserve assets (excluding gold)	2,400	3,013	3,783	5,334	5,651

EXTERNAL TRADE

	1998	1999	2000	2001	2002
	Mio ECU/euro				
Trade balance	-3,269	-3256	-3775	-5031	-6139
Exports	3,920	3999	4822	5214	5188
Imports	7,189	7255	8597	10245	11327
	previous year=100				
Terms of trade	101.2	100.3	107.1	98.9	99.5
	as % of total				
Exports with EU-15	47.7	48.9	54.4	54.1	52.9
Imports with EU-15	59.3	56.6	55.4	57.1	55.8

The values of exports, imports and balance of trade for the years 1998 and 1999 have been calculated on the basis of the exchange rates of the Croatian National Bank, situation as on the last day of the year. The exchange rate for the year 1998 was 1 EUR equals 7.3291 Kuna and for the year 1999 it was 1 EUR equals 7.679009 Kuna. For the period 2000 – 2002, the values have been re-calculated in EUR according to current daily exchange rates of the Croatian National Bank (middle rate) valid on the day customs duties are levied.

Terms of trade have been calculated on the basis of the exports and imports values expressed in USD.

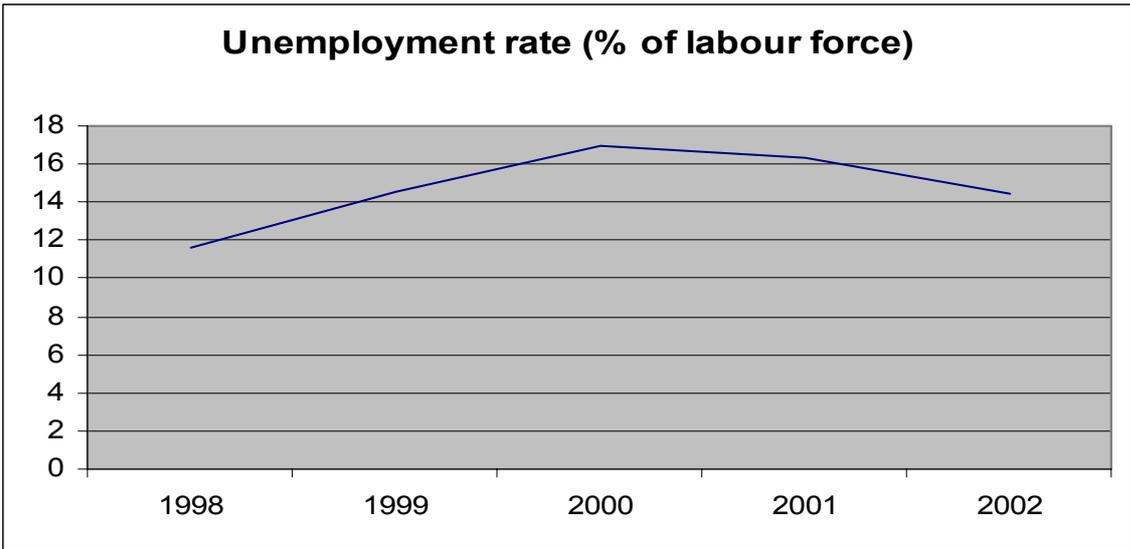


LABOUR MARKET

	1998	1999	2000	2001	2002
% of population					
Economic activity rate (15 - 64)	62.8	60.2	62.2	62.2	62.9
Employment rate (15-64), total	55.3	53.2	51.3	51.8	53.6
Employment rate (15-64), male	61.7	60.2	57.4	59.0	60.1
Employment rate (15-64), female	49.4	47.7	45.5	44.9	47.4
% of total					
Average employment by NACE branches					
- Agriculture and forestry	16.5	16.7	11.7	15.5	14.9
- Industry (excluding construction)	23.5	23.9	22.7	23.1	23.0
- Construction	6.7	6.6	5.9	6.3	6.6
- Services	53.3	52.9	59.4	55.0	55.4
% of labour force					
Unemployment rate, total	11.6	14.5	17.0	16.3	14.4
Unemployment rate, males	10.7	13.5	15.9	14.4	13.3
Unemployment rate, females	12.6	15.7	18.2	18.7	15.8
Unemployment rate of persons < 25 years	31.0	39.2	43.1	41.7	34.4
% of all unemployed					
Long-term unemployment share	46.0	50.2	53.6	55.3	53.1

Unemployment rate by NUTS III region	% of labour force				
County of Zagreb			20,0	23,0	24,4
County of Krapina-Zagorje			17,1	19,4	20,5
County of Sisak-Moslavina			27,4	32,2	35,0
County of Karlovac			31,1	33,1	32,9
County of Varaždin			17,6	17,8	18,2
County of Koprivnica-Križevci			16,9	18,4	21,0
County of Bjelovar-Bilogora			27,2	28,9	31,3
County of Primorje-Gorski kotar			18,9	19,8	18,9
County of Lika-Senj			25,5	27,9	30,9
County of Virovitica-Podravina			26,2	28,7	32,9
County of Požega-Slavonia			26,0	27,9	29,5
County Slavonski Brod-Posavina			33,7	34,5	36,3
County of Zadar			31,4	32,2	33,0
County of Osijek-Baranja			28,7	30,8	32,4
County of Šibenik-Knin			36,4	38,8	39,6
County of Vukovar-Sirmium			37,7	40,1	40,8
County of Split-Dalmatia			29,1	30,1	30,8
County of Istria			15,2	14,9	14,9
County of Dubrovnik-Neretva			24,4	24,9	26,3
County of Međimurje			19,3	19,1	19,8
City of Zagreb			11,6	13,3	13,9

Unemployment rate on county level (NUTS III) given according to administrative sources as of 31 March, so data are no comparable with unemployment rate from LFS. Data on county level exclude persons in employment in police and defence.



INFRASTRUCTURE

	1998	1999	2000	2001	2002
	in km per 1000 km ²				
Railway network	48.2	48.2	48.2	48.2	48.2
	km				
Length of motorways	330.4	381.6	410.6	428.8	454.9

INDUSTRY AND AGRICULTURE

	1998	1999	2000	2001	2002
	previous year = 100				
Industrial production volume indices	103.7	98.6	101.7	106.0	105.4
Gross agricultural production volume indices	110.1	98.8	88.7	108.5	107.7

STANDARD OF LIVING

	1998	1999	2000	2001	2002
	per 1000 inhabitants				
Number of cars	222.2	233.5	256.8	269.4	280.1
Main telephone lines	349.4	360.3	329.9	401.9	411.3
Number of subscriptions to cellular mobile services	39.3	79.3	253.8	390.1	572.4
Number of Internet subscriptions	8.7	16.5	33.8	53.8	83.5

Subscriptions to cellular mobile services include both prepaid and post-paid users.

Internet subscriptions include subscribers via modem and via leased lines.

TERTIARY EDUCATION

	1998	1999	2000	2001	2002
	in % of total age group (18-24)				
Participation rate for persons aged 18 to 24	27.3	26.1	28.2	29.5	31.6

The figures about tertiary education are calculated as percentage of enrolled students in tertiary education divided by total population aged 18-24. The total number of population aged 18-24 is (with exception of 2001) estimated

AREAS OF SPECIAL STATE CONCERN (ASSC)

