

# Croatia

<b>Status Index</b> (Democracy: 9.10 / Market economy: 8.32) <b>8.71</b>		<b>Management Index</b> <b>6.88</b>	
<b>HDI</b>	0.841	<b>Population</b>	4.5 mn
<b>GDP per capita (\$, PPP)</b>	11.080	<b>Population growth<sup>1</sup></b>	0.2 %
<b>Unemployment rate<sup>2</sup></b>	19.5	<b>Women in Parliament</b>	21.7 %
<b>UN Education Index</b>	0.90	<b>Poverty<sup>3</sup></b>	4%
		<b>Gini Index</b>	29.0 (2001)
Source: UNDP: Human Development Report 2005. Figures for 2003 unless otherwise indicated. <sup>1</sup> Annual Growth between 1975 and 2003. <sup>2</sup> International Labour Office, average registered unemployment in 2003. <sup>3</sup> Population living below \$ 1 (1990- 2003).			

## A. Executive summary

Having suffered a serious transformation crisis, war and political isolation in the 1990s, Croatia has rapidly advanced political and economic transformation since January 2000 with success. This dynamic was brought about by political change marked by the end of Croatian Democratic Union (HDZ) rule. The HDZ had ruled since independence. The commitment to democracy and market economy then underlined has begun again since the re-election of the reformed HDZ in 2003.

The realization of these parliamentary elections and the manner in which successive government change was conducted indicate further development in Croatia's democratic structures. Improvements in state capacity, political participation and the rule of law underscore this development. While the judiciary operates relatively independently, it is partially limited in carrying out its functions. Improvements are needed, particularly with regard to procedural rationalization and the administration of justice. Because the judicial system's budget has been increasing since 2003 in the course of adopting EU-standards, the number of untreated cases is likely to decline and the fight against corruption reinforced.

Croatia's economy is succeeding as well. GDP averages approximately 4% and is linked with controllable macroeconomic data. High, persistent unemployment and foreign and trade deficits remain key problems. They underline the Croatian economy's insufficient competitiveness, which is rooted in a low share of the private economy, insufficient restructuring, flawed protection of property rights and monopolistic structures. However, recent competition policy enforcement, amendments to security and bankruptcy laws in 2003, the highly-developed banking sector, and continuing improvements in the institutional framework for private entrepreneurship have laid the foundation for future competitiveness.

However, an increased emphasis on investment in education and research and development is necessary. These favorable developments in Croatia were confirmed by the EU Commission's positive response to Croatia's accession aspirations and its subsequent acceptance as a member country in summer 2004. Croatia's EU ambitions, which are supported by all parties in parliament as shown in the 2002 resolution, have revived cooperation with international organizations such as the ICTY and strengthened relations with NATO. Local organs have been granted more legal and financial autonomy in the last three years as the administration has been decentralized.

Anti-democratic actors with veto powers no longer play a key role in Croatia and extremist parties have lost considerable influence in recent years. Amendments to minority protection were made in 2002. 2003 saw limited polarization related to residual ethnic tensions with the return of displaced Serbian refugees into the Krajina or Eastern Slavonia. The participation of the Serbian minority in the 2003 elected government contributed further to establishing peace and reconciliation.

## **B. History and characteristics of transformation**

Until independence, the Republic of Croatia was a constituent republic within the Socialist Federated Republic of Yugoslavia. In May 1991, 94% of the Croats voted for independence that was formally declared on June 25<sup>th</sup>, 1991 in Zagreb. Before Croatian Democratic Union, the HDZ (Hrvatska Demokratska Zajednica), a kind of catchall for nationalist factions, captured a majority of votes in elections held in May 1990. Franjo Tuđman, chairman of the party and a former general and nationalist dissident under Tito, became the first president of Croatia.

The task of establishing a new state—the new constitution was passed on December 22, 1990—was accompanied by political and economic transformation toward democracy and a market economy. Croatia then suffered a serious transformation crisis—a decrease in industrial production of about 50% and a rapid increase in unemployment—that was exacerbated by the war. Until the mid-1990s, rebellious Serbs occupied up to 30% of its territory; as a result, important connections between the capital of Zagreb and Slavonia and sections of the Dalmatian coast were seriously disrupted or even severed completely. At the same time, the democratization of the country advanced only cautiously. Failures at the political level, the authoritarian leadership style of Franjo Tuđman, the military reconquest of the formerly occupied areas in Western Slavonia and the Krajina, and a lack of willingness to cooperate with international organizations increasingly isolated the country politically and economically in the latter half of the 1990s. Consequently, Croatia remained one of the few transformation countries in Central and Eastern Europe not participating in NATO's Partnership for Peace and without an association agreement with the EU by the end of 1999.

In the area of market transformation, the reform policy of the 1990s attained some success, despite difficult structural conditions. The passage of the new economic program that established a private property regime and the macroeconomic stabilization program in the autumn of 1993 formed the foundation for a market-based economic regime. With the help of restrictive loan, finance and income policies, inflation was brought under control. On the microeconomic level, especially in the development and strengthening of the private sector, the reform policy achieved less. Privatization proceeded under an inconsistent stop-and-go policy against the backdrop of political power struggles. Minimal transparency in ownership conversions and preference for insiders discouraged foreign capital and resulted in insufficient restructuring and modernization in the business sector. This, in turn, led to low competitiveness of the Croatian export economy and rising trade deficits.

After Tuđman's death, the governing HDZ suffered a devastating loss in the parliamentary elections of January 2000. A broad center-left coalition of six parties under the leadership of the social democrats (SDP) won a majority and elected the premier, Iвица Račan. This change in political direction was accompanied by a reorientation of Croatian transformation. The constitutional amendments of November 2000 and March 2001 introduced a parliamentary system of government, ending the system of a dual executive and of the president's superior power position.

Improvements in the balance of democratic transformation are closely connected with increased cooperation with external actors (EU, WTO, CEFTA, IMF). Simultaneously, Croatia realized a significant economic catching-up process that was honored by the EU with the signature of the Stabilization and Association Agreements and the opening of an accession perspective. This positive trend was confirmed also after the parliamentary elections in November 2003 that induced a repeated change of the government. The reformed HDZ became the strongest force, its chairman Ivo Sanader the new prime minister. Following the official application for EU membership in 2003 and the Commission's positive response, Croatia was awarded candidate status in summer 2004.

## **C. Assessment**

### **1. Democracy**

Since 2000, Croatia has made immense progress in transforming its regime toward democracy; the results thereof came into fruition during the period under review. Parliamentary elections at the end of 2003 and the manner in which the successive change of government was conducted indicate further democratization.

Consequently, the European Commission has evaluated Croatia's EU accession application positively; Croatia was accepted as a candidate country in June 2004.

### **1.1. Stateness**

Since the 1990s, Croatia has extended the state's monopoly on the use of force, which is free from any limitations, over the entire national territory. All citizens have the same civic rights and the majority acknowledges the constitution in principle. Deeply rooted within Croatian society and culture, the Catholic Church is seen as an identity-creating element. Nevertheless, state and religion are separate to the greatest possible extent; political processes are secularized. Public security and order are ensured. The state is present with basic administrative structures throughout the entire territory.

### **1.2. Political participation**

The population determines the head of government through free and fair elections without government restrictions. This was illustrated clearly both by the smooth second parliamentary elections after the end of the Tuđman era in November 2003 and the presidential elections at the beginning of 2005 when President Mesić was confirmed for five more years. Elected officials have the power to govern, there are neither actors holding veto powers nor political enclaves in the hands of the military. Elected representatives demonstrate determinedly that interference in politics by the military is under no circumstances tolerated. Thus, President Mesić uncompromisingly forced seven generals into retirement in 2002 after they had attracted media attention with political statements. There is freedom of association and assembly within the framework of the democratic order. The work of independent trade unions was not disrupted. During the period under review, freedom of speech and the press were further improved. In February 2003, a new radio and television law was passed which was positively assessed by the OSCE. However, opportunities for sporadic influence on the state media remain; this state of affairs demands additional reforms.

### **1.3. Rule of law**

From the constitutional changes at the beginning of 2000 until this writing, continuous improvements concerning the delimitation of competences between government, parliament and judiciary can be observed, so that in principle there are no limitations on the basic functioning of the separation of powers. This was confirmed in the April 2004 reports of the European Commission on Croatia's eligibility to join the EU. The judiciary operates relatively independently; leeway

for unconstitutional interference is shrinking due to the constitutional changes of November 2000 and March 2001.

However, based on insufficient functional penetration, the functioning of the judiciary is partially limited. Improvements especially in the area of a rationalization of procedures and the administration of justice are thus still necessary. Foremost, the number of cases not yet handled must be reduced, and the systematic application of modern information and communication technologies must be promoted. In the context of the adoption of EU standards, the budget for the judicial system has been increased by 16% in the 2003 budget; for 2004 and 2005, further funding has been planned with the support of the World Bank and the CARDS program. The new government led by Sanader continues the efforts to punish abuse of authority politically and legally that were initiated under the former Prime Minister Ivica Račan. For example: the Foreign Minister Žužul resigned following a corruption affair. This clearly indicates a move toward increased credibility and signals an obvious improvement. Civil liberties are generally respected; when violated, suit can be filed to enforce them.

#### **1.4. Stability of democratic institutions**

Since the change of government in 2000 and constitutional changes that transformed Croatia from a semi-presidential to a parliamentary system of government, democratic institutions in Croatia can be described as stable and capable of performing their functions. The 2000 parliamentary elections brought a coalition of parties into power that was then able to establish a more precise and restrictive definition of the constitutional powers of the president. These amendments in turn strengthened the constitutional position of the government and the parliament. This development has continued under the change of government in 2003. Supporting these developments are the approximately 500 laws and bills that have been introduced in the Sabor, the Croatian Parliament, and mostly implemented within a gradual alignment of Croatia's institutional framework to EU standards over the last three years. According to figures by the Croatian government, about 50% of the laws were up to the mark of the *acquis communautaire* at the end of 2004. Democratic institutions are accepted by the relevant political and social actors and considered legitimate.

#### **1.5. Political and social integration**

The Croatian party system is still subject to fluctuations, characterized by a medium-to-high degree of fragmentation, a moderate level of voter volatility, and a high degree of polarization. Since 2000, the political landscape has been changing, as new parties have been founded and existing parties have dissipated.

Altogether, the number of political parties in the Sabor has increased. This could also be observed in 2002 when the new HDZ-chairman Ivo Sanader tried to prune the party of old hard-liners to create a democratic and pro-European party. Some of the mostly national parties settled on the right edge of the political spectrum, like Hrvatski Blok (HB), led by Ivič Pasalić, and Hrvatski istinski preporod (HIP), could attract only few voters - registering less than 2% - and thus failed to enter the Sabor. In the last two years, the trend of founding new parties has been weakening. In fact, few parties have as long a tradition and are as anchored in society as the HSS (Hrvatska seljacka stranka). Limited program capability and weak social integration can often be observed. In addition, some parties are unilaterally oriented toward their regional constituencies as the IDS (Istarski demokratski sabor) and the PGS (Primorsko goranski savez).

The network of interest groups has become more closely knit in the last three years and the willingness for cooperation and intermediation between the society and the political system exists in embryonic form. In the period considered, the significance and autonomy of trade unions has been increasing; close to 70% of all workers are organized today. The population's approval of democracy is medium to high, political protests target those currently in power and do not question the institutional framework.

## **2. Market economy**

### **2.1. Level of socioeconomic development**

With a per capita GDP of \$5,350 in 2003 (World Bank data), Croatia is the highest-income country in southeastern Europe and the second wealthiest successor state of the former Yugoslavia. Social exclusion is quantitatively and qualitatively limited and structurally not significantly ingrained. According to a World Bank survey for 2000, 4% of the population lived on less than \$4.30 per day, indicating a relatively low level of absolute poverty. Also, the Gender-related Development Index (Gini) coefficient of 0.29 (based on World Bank data from 2004) represents only moderate social disparities. Yet, regional disparities exist and predominantly the former war-torn areas still suffer from an underdeveloped economic framework. Gender discrimination is not apparent; UNDP's 2004 Gini ranks Croatia 43<sup>rd</sup> of 144 countries with an index value of 0.827.

### **2.2. Organization of market and competition**

Market competition in Croatia has a strong institutional framework - independent price determination, freedom of pricing and free use and transfer of profits are guaranteed, yet occasionally institutional rules are inconsistently applied to the market participants.

The scope of the state sector is still substantial, the share of the private sector in the GDP is about 60%, which is quite small compared to some other eastern European transition countries, although private enterprises find favorable legal conditions that are reflected in the EBRD extensiveness legal indicators. Company laws were adopted at an early stage of the transition process, as well as security and bankruptcy laws that were amended and improved in 2003. Nevertheless, problems remain in such issues as enforcement. The judicial and administrative systems are unable to enforce commercial law as they suffer from inconsistency, over-regulation, and frequent changes.

Although the equal treatment of foreign investors and companies is a declared principle, in practice the entry or operation in the market is difficult for foreigners as they may face intricacies of obtaining work permits, visas, construction permits and discriminatory or burdensome regulations on the municipal level. The formation of monopolies is regulated inconsistently, but there are considerable signs of improvement; the number of competition cases has been considerable and is increasing. The competition law largely follows the German model. Foreign trade has been extensively liberalized in the context of integration into the WTO and the approach to the European Union. Special rules for certain branches are being eliminated, although non-tariff barriers that include strict testing and certification requirements for some foods, pharmaceuticals, and electronics are still effective.

Croatia has an internationally competitive and increasingly differentiated banking system that is generally oriented to international standards. Foreign banks hold 90.82% of the assets of 41 banks currently operating in Croatia. For the moment, concentration remains high, but is on the decline; four banks hold 61.09% of all assets. Intermediation is high compared to other transition economies. However, vulnerability to fluctuations due to dependence on external factors and a lack of supervision continues, although the banking sector has improved since the financial crisis in 1998-1989. Contrary to the well-developed banking sector, capital markets remain underdeveloped with a low market capitalization of 16.1% in 2002. The underdevelopment of the two Croatian stock exchanges primarily results from a supply problem created by a lack of large companies with substantial free-floating shares.

### **2.3. Currency and price stability**

Inflation and foreign exchange policies are brought into line with other goals of economic policy and are institutionalized in an independent central bank. Inflation is generally under control and averaged approximately 2% in the last three years. In accordance with its main goal of price stability, the Croatian National Bank has

implemented an exchange rate regime of managed floating, keeping the fluctuation of the Kuna to the German Mark or the Euro respectively in a narrow band of 6% around the average exchange rate. Thus, there is a consistent policy for macroeconomic stability. Yet, the outstanding external debt grew in 2002 and 2003, when the external debt-to-GDP ratio amounted to 81.9%. Tailored fiscal policies are needed to further reverse the trend that has been decelerating in the first three quarters of 2004.

#### **2.4. Private property**

In principle, property rights and the regulation of the acquisition of property are well-defined, yet there are problems with their implementation that have, however, been recently decreasing. According to the Heritage Foundation Index of Economic Freedom, the court system remains cumbersome and inefficient. The public sector has thus to improve its performance in protecting property rights and ensuring the effective functioning of the judiciary, especially as the deficiencies may hinder high technology development on account of poor protection of intellectual property rights. Problems related to land acquisition, registration, and site development pose an additional hindrance. Private companies are viewed institutionally as the primary engines of economic progress and are thus given appropriate legal safeguards. Nevertheless, the private sector share of 60% in GDP remains comparatively low, so that remaining state enterprises need to be privatized. The pending privatization of formerly socially owned enterprises proceeds in principle under the criterion of medium-term profitability and in accordance with other market principles. For example, the privatization of the oil company INA Industrija Nafta d.d. has been announced to continue in 2005, with the Croatian state planning to sell all or part of its remaining stake to attract new FDI.

#### **2.5. Welfare regime**

Social networks are well-developed in part but occasionally fail to cover all risks for all strata of the population; the risk of poverty continues for some segments of the population. For example, 32.4% of the unemployed lived with an income below the at-risk-of-poverty threshold (60% of national median net income) in 2003. A number of institutions exist that compensate for gross social differences that are only sporadically insufficient. Having faced a fiscally unsustainable pay-as-you-go pension system accompanied by an unfavorable demographic trend, the Croatian government passed legislation to bring the pension system in line with European countries by establishing individual accounts and offering private investment options for a portion of the funds. Other risks associated with poverty remain for some sections of the population. The high share of unemployed,



although declining, represents a burden on social insurance systems. Women have significant access to higher education and public office. They accounted for 21% of parliamentarians in 2003.

## **2.6. Economic performance**

The growth of per-capita GDP, averaging around 5% in 2002 and 2003, is relatively high and associated with positive or controllable macroeconomic data. Inflation was 2.1% in 2004 and has been generally under control ever since the introduction of the Kuna. Even though growth rates point to considerable gains of the Croatian economy, other indicators underline the fact the transition process in Croatia is far from being completed. The current account deficit has widened again in 2002 and in 2003, driven by a continuously increasing trade deficit that, however, declined in 2004. The unemployment rate is at 19% and continues to be one of the most pressing problems, particularly as the share of long-term unemployment is increasing and accounts for 54% of total unemployment, although the total rate is slowly shrinking.

The growth potential of the Croatian economy in the light of forthcoming EU integration and improved regional cooperation within the SAA can be classified as favorable, given further restructurings in the enterprise sector. Largely increasing private consumption drove GDP growth, however, the stimulus of credit growth for domestic demand is weakening, so that other drivers of progress need to be stirred. Whereas the service sector has been performing successfully over the last years, the development of a more modern and internationally competitive industrial sector is needed that can be achieved by a stronger orientation towards innovation and research and development.

## **2.7. Sustainability**

Although environmental issues are increasingly taken into account in key sectors of economic life, they tend to be subordinated to growth efforts. Croatia has ratified the Cartagena Protocol on Biosafety, the Framework Convention on Climate Change and the Convention on Biological Diversity, and signed the Kyoto Protocol. In addition, Croatia adopted the National Environmental Action Plan in 2002. Responsibilities are clearly assigned to the Ministry of Environmental Protection, Physical Planning and Construction. The commercial sector, most notably the tourism industry, also competes by underlining its commitment to ecologically sound growth. Positive tendencies are likely to intensify in the process of adopting EU standards.

State as well as private institutions for education, training and research and development are strong and quite advanced in substantial fields of economic life. Quantitatively and qualitatively, investments in R&D are average, with 1.25% of GDP in 2001 substantially lower than the EU average (2.21%), but higher than in most of the new EU member states. Croatia's educational structure shows that most individuals have achieved intermediate education levels; the percentage of those with higher education is substantially below the EU average. However, greater numbers of young people are finishing secondary school, which provides a favorable basis for increasing the percentage of highly educated persons. 4.2% of GDP was invested into the education system between 1999 and 2001 (UNDP data).

### **3. Management**

On November 23, 2003, parliamentary elections were conducted in Croatia that led to a change in government. This is why the following analysis covers the attainments of both governments: the center-left coalition formed by the Social Democrats (SDP), the Croatian Peasant Party (HSS), the Croatian People's Party (HNS) and the Liberal Party (LS) under Ivica Račan and the HDZ-led government under Ivo Sanader since the elections that depends on the support of the Croatian Party of Pensioners (HSU), the Democratic Center (DC), the Croatian Social-Liberal Party (HSLS) and representatives of parties of the national minorities.

#### **3.1. Level of difficulty**

Decisive steps towards democracy had already been taken in the period between 2000 and 2003 under the Račan government. Structural limitations have therefore been moderate since then. However, the country has yet to complete its transition process. Despite continuous economic growth since the mid 1990s, GDP in 2003 remained below the pre-war level of 1990. Especially high unemployment and the insufficient competitiveness of the economy - a consequence of often apologetic restructuring - have left the new government under Sanader with difficult economic conditions.

In addition, society is still struggling with the heritage of authoritarian political structures, especially concerning the people's trust in the state institutions. Under Communism, but also during the 1990s, civil engagement was under-promoted and often even suppressed. According to studies conducted by the International Republican Institute and the Civicus Index 2001, the government viewed the work of NGOs with great criticism and NGOs found little support among the population. Civil society traditions may thus be evaluated as weak to moderate, "social trust" and a "civic culture" of participating in public life are rudimentary.

At the start of the period under review, a strong political polarization between both political camps (SDP - HDZ) was observed, particularly concerning the surrender of Croatian generals accused by the Hague Tribunal. Although reinforced minority rights and the pursuit of increasingly prudent politics since 2000 eased ethnic tensions, some incidents of polarization continued concerning ethnic issues with the return of displaced Serbian refugees into the Krajina or Eastern Slavonia in 2003.

### Profile of the Political System

	Regime type: <i>Democracy</i> System of government: <i>Parliamentary</i>
	1. Head of State: <i>Stjepan Mesic</i> Head of Government: <i>Ivica Racan</i> Type of government: <i>oversized coalition</i>
	2. Head of Government: <i>Ivo Sanader</i> Type of government: <i>coalition minority</i>
Source: BTI team, based upon information by country analysts, situation in July 2005. Constraints to executive authority (1-6 max.) measures the institutional votes gained by party i; $p_i$ is the share of parliamentary mandates controlled by party i. Effective number of parties denotes the number of parties represented in	

### 3.2. Steering capability

Whereas the center-left coalition under the social democrat (SDP) Ivica Račan was devoted to creating security domestically and abroad and meeting the criteria for the transition to a free market democracy, efforts have been decreasing since the beginning of 2003. Announced measures in the area of market economy reforms, such as the reduction of the ratio of government expenditures to gross national product, the depletion of subsidies, the enforcement of a competitive framework, and the creation of more flexible labor markets have been delayed. Unfavorable performance has precipitated corresponding evaluations. According to a poll conducted by the Croatian newspaper *Večernji list* in 2003, 68% of the respondents gave the Račan government a bad performance rating in the area of economic policy. The declining commitment to reforms has been rooted in increasing political tensions within the coalition (mostly concerning delivery requests of the ICTY and individual privatization plans) and in the shrinking majority, resulting from coalition partners having left the coalition. Both the HSLŠ, led by Dražen Budiša, and the IDS left the coalition. These events, combined with the then-approaching parliamentary elections in 2003, accounted for the extrusion of a long-term and consistent domestic policy in favor of short-

term political interests.

However, a consistent procedure can be certified with respect to the Račan government's efforts to approach the EU. After the official application for membership, dated February 21, 2003, numerous laws and bills have been introduced in the Sabor to ensure that Croatia will be prepared for subsequent accession negotiations by a continuous implementation of *acquis communautaire*. The set of questions on the status quo of reforms and the country's ability to accede, delivered by the European Commission in 2003, was received on schedule in autumn 2003, which paved the way for another step toward Brussels.

When the HDZ opposition party resumed power between January 2000 and November 2003, policies pursued by the former government under Račan were essentially continued. The new HDZ committed itself to the principles of democracy and market economy; Western observers evaluated the first measures as positive.

### **3.3. Resource efficiency**

Despite improvements, the government is not entirely efficient in its use of available economic, cultural and human resources. Personnel expenditures remained relatively high, both until the end of 2003 and until January 2005. Budget deficits (4.6% in 2003) and state indebtedness are persistent in relation to GDP. The Račan government was able to realize parts of the announced reforms, i.e. in the area of providing infrastructure through a large-scale upgrading of the motorways, yet microeconomic adjustments, in particular, remain behind planned targets. Although urgently needed, significant reform of the country's health system has yet to be undertaken. Minister Hebrang, who was in charge of the health system, had to resign for sanitary reasons. Efforts to fight corruption remain behind domestic planned targets—also those set by the EU. Nevertheless, the government seeks to provide all integrity mechanisms.

There have been considerable improvements made in the period considered, especially concerning the decentralization of administration. Local organs of self-administration have been granted more legal and financial autonomy in the last three years. The administrative division of the country into individual counties (*Županije*), however, is problematic in terms of its efficiency, especially with regard to structural funds provided by the EU. The responsible actors are thus dividing the country into four units for the purpose of surveys conducted by the Central Bureau of Statistics. To be eligible for EU funding, regions must fill several criteria, including that of having a population between 800,000 to 3 million and a certain GDP level, which makes statistical restructuring necessary.

The government tries to coordinate conflicting objectives with increasing success,

so that intra-governmental frictions are diminishing. Especially the integration of the Serbian minority's party SDSS (Samostalna demokratska srpska stranka) into the coalition can be evaluated as a step in this direction. After the law on the Rights of the National Minorities that regulates the parliamentary representation of all minorities living in Croatia had been passed on December 13, 2002 with a high majority of votes, the participation of the Serbian minority in the government contributed further to establishing peace and reconciliation and was appreciated both by representatives of the minorities and the international community.

Recruitment procedures are not always devoid of political influence, although improvements over the previous government's practice can be observed. In December 2004, just after the date for the start of the accession negotiations was announced, the selection process of those experts that are to lead the negotiations with Brussels began. This will show to what extent the government will deliver on its promise to increase transparency and make competency rather than party membership the selection criteria. The resources of skilled and highly educated experts appear limited. Often, these individuals are moved from important departments.

Furthermore, the government fails to make sufficient use of the large Croatian diaspora and integrate the country into international structures on diplomatic, economic and scientific levels. However, there are attempts to improve this situation. In November 2004, a congress of Croatian scientists, both domestic and from abroad was organized for the first time in Zagreb. The congress aimed to link human resources more closely to improve Croatia's international integration.

### **3.4. Consensus-building**

There is consensus on the need to build democracy and a market economy among all major political actors, i.e. Premier Sanader, President Mesić and all representatives of the Sabor parties. As this consensus existed under the former government as well as the Sanader-led government, there were no significant surprises when the government changed at the end of 2003. Membership in the European Union and NATO has been and remains the well-defined target. This was confirmed by a meeting of the Croatian parliament on December 18, 2002 when a resolution on Croatia's accession to the EU was passed with the consent of all parliamentary parties. The resolution also underlined the unconditional political support for all activities within the framework of the Stabilization and Association Agreement.

Anti-democratic actors with veto powers no longer play any essential role in Croatia, as was confirmed by the last parliamentary elections. Extremist and anti-European parties were marginalized and obtained only one to 2% of all votes. It is

unlikely that the reform course will be reversed. In addition, extradition requests from The Hague and Brussels for the fugitive General Ante Gotovina, which prompted heated debate in the Sabor a few years ago, today fail to challenge basic political orientation. Even within the ranks of the HDZ, there is consensus on the need to increase efforts to trace the general and deliver him if accession negotiations are to begin. Government efforts have encouraged expressions of social solidarity, which had not been marked before. This includes an attitude of reconciliation on the part of the new and former government toward ethnic minorities and the call for greater tolerance in society. Examples include the participation of the Serbian Party in the coalition as well as the prime minister's visit at the Serbian Orthodox Community in Zagreb, which was viewed as a clear signal and call for tolerance within society.

### **3.5. International cooperation**

Having signed the Stabilization and Association Agreement with the EU in 2001, Croatia paved a path to various financial support programs. Technical and financial support, combined with funds provided by the World Bank, were used for institutional improvements and the adjustment to EU standards that have proven successful under both governments. Infrastructural upgrading and continued decentralization were emphasized in particular. Croatia received approximately €550 million, provided by EU programs as CARDS until the end of 2003. Related to continued EU accession efforts, another €100 million within the framework of PHARE and ISPA for 2005 and approximately €140 million from SAPARD for 2006 are included. These funds will be spent on necessary reforms in the areas of agriculture, the judiciary and administration. The funds of the World Bank and different donor states were used for a reform of the land registry and cadastre.

Further democratic transition is closely linked to increased cooperation with international organizations. The international community deemed both Račan and Sanader as reliable and accountable. Brussels in particular sent positive signals at the end of 2004. According to Javier Solana, Croatia made great progress in the last three years and is increasingly proving its political maturity. Positive developments are also obvious in relations with NATO. Croatia has been participating in the "Partnership for Peace" since May 25, 2000 and been a member of the aspirants' "Vilnius-Group." Croatia has also been taking part in NATO's "Membership Action Plan"(MAP).

Croatia's international rating has improved because of its reform efforts and moves toward EU accession. Immediately following the announcement of the prospective date for the start of accession negotiations, Croatia's Standard & Poor rating increased from BBB- to BBB. It thus outperforms the two accession

candidates Bulgaria and Romania.

However, the Sanader government still faces several challenges to fulfill all conditions imposed by international organizations, such as compensation for Serbian refugees' destroyed property and facilitating their return to Croatia. Croatia's relationship with the ICTY remains a weak spot. Although the government exhibited willingness to cooperate in the last three years and heeded the Tribunal's extradition requests for Ademi and Norac (the accused generals Markač and Čermak traveled willingly to the Netherlands in 2003), the government has yet to convince Chief Prosecutor Carla del Ponte that it is willing to trace fugitive Ante Gotovina and deliver him, should he actually be in Croatia. The failure to seize Gotovina caused the EU to postpone the start of accession negotiations.

The extremely short period of time in which Croatia was able to move from applicant to candidate for EU membership could serve as an example of successful EU integration for the remaining Western Balkan states. Both Croatian governments actively contributed to improved regional cooperation, and their policies have since played a stabilizing role in the peace-building process within the region. Free trade agreements have been signed with all neighboring countries. In November 2004, a mutual agreement on the protection of their respective minorities was signed by Croatia and Serbia and Montenegro. However, some problems remain with the unresolved border disputes on land and at sea with Slovenia and the two open disputes over the Krško nuclear power plant and Novo Ljubljanska Banka.

#### **4. Trend of development**

##### **4.1. Democratic development**

Since January 2001, stateness, political participation and the rule of law have improved considerably; the level of democratic consolidation has increased. This positive trend has continued since the renewed change of the government in 2003. Anti-democratic actors with veto powers no longer play any key role in Croatia. Improvements concerning the freedom of opinion and the media must also be emphasized as competencies between the government, parliament and judiciary have been further delineated. In the last two years, Croatia has succeeded in decentralizing its administrative structures in favor of strengthened local congregationalism. Improvements particularly in the area of a rationalization of procedures and the administration of justice remain urgent. The progress made in democratic transition since 2001 is closely linked to increased cooperation with international organizations that provides Croatia access to several support programs. These positive developments were confirmed by the EU Commission's

positive response to Croatia's accession request and its subsequent acceptance as a candidate country in summer 2004.

#### 4.2. Market economy development

In the period under consideration, the institutional framework in Croatia has improved significantly and adjusted to EU Standards as demanded in the *acquis communautaire*. The increased inflow of foreign direct investment, which significantly contributed to the recovery of the Croatian banking system, is closely linked to improved integration in the European single market. Only the private sector's share of about 60% of GDP is unfavorable. In terms of privatization and the consequent implementation of legal regulations, leeway for reforms remains. Croatia's stage of development has improved slightly over the last four years; between 2001 and 2004 the economy was able to realize growth rates of 4% on average. However, this positive trend is largely consumption-driven; sustainable economic progress will require deeper restructuring in the enterprise sector and an increased competitiveness.

**Table: Development of macroeconomic fundamentals (2000-2004)**

	2000	2001	2002	2003	2004
Growth of GDP <sup>1</sup> [in %]	2.9	4.4	5.2	4.3	3.8
Export growth <sup>2</sup> [in %]	18.6	5.6	-1.4	7.3	16.9
Import growth <sup>2</sup> [in %]	18.1	15.2	9.7	13.1	5.4
Inflation <sup>3</sup> [in %] (CPI)	6.2	4.9	1.7	1.8	8.5
Foreign Direct Investment <sup>4</sup> [in % of GDP]	5.9	7.2	3.9	4.9	na
Tax Revenue in % of GDP <sup>5</sup>	42.1	40.5	40.5	40.2	na
Unemployment <sup>6</sup> [in %]	21.1	22.0	22.3	19.2	na
General government balance <sup>4</sup> [in % of GDP]	-6.5	-6.8	-4.8	-4,6	na
Current account balance <sup>4</sup> [in million US\$]	- 460	- 726	- 1 613	-1718	na

<sup>1</sup> Eurostat, figure for 2004 is estimated. <sup>2</sup> Own calculations based on data provided by Republic of Croatia - Central Bureau of Statistics <sup>3</sup> Croatian National Bank. <sup>4</sup> EBRD, projection for 2003. <sup>5</sup> IMF, IMF Country Report No. 04/251, Republic of Croatia: Selected Issues and Statistical Appendix, August 2004. <sup>6</sup> Croatian Employment Service, registered unemployment.

#### D. Strategic perspective

There are short- to medium-term strategic tasks in the areas of administrative structure and judicial administration reform, particularly with regard to shortening



the duration of litigation. Measures initiated to fight corruption must be continued and strengthened. Now that the legal context for minorities has improved considerably, the international community expects increased efforts to facilitate the return of displaced ethnic Serbs to Croatia. The adjustment of the institutional framework to EU standards is proceeding; there is leeway for enforced reforms in the areas of agriculture, environmental protection, reduction of subsidies, and free movement. The distinct EU support programs to which Croatia has gained access will be helpful in realizing the remaining reforms.

As Croatia proves to be continuously stable in macroeconomic terms—excepting the high foreign debt—the key economic task is to increase competitiveness and to improve the investment climate. As of yet, bureaucratic barriers remain considerable; founding a new business takes on average 51 days. Establishing the long-discussed “one-stop-shop” might help overcome these hurdles, as might urgently needed reforms of the land registry and cadastre. EU evaluation of Croatia’s ability to join the common market shows that enterprise restructuring has thus far been insufficient.

Increased commitment to tackling the problem of privatization is therefore necessary. The path toward EU membership and candidate status facilitates the access to capital and renders it less expensive; increasing stability and security are likely to attract further investors. Since the majority of foreign direct investments have targeted the service sector, especially banking and telecommunications, manufacturing and tourism will have to attract foreign direct investment if they are to become more competitive.

Future competitiveness requires guaranteeing the ability to permanently withstand the pressures of the sophisticated EU single market and further investment in research and development and the education system. The continued path toward EU membership provides access to funds, the opportunity to participate in research networks, and is likely to contribute to technological progress and a reorientation toward long-term competitive structures. Likewise, an increased willingness to cooperate on a regional level provides Croatian business the opportunity to revive old channels of sale, and to benefit from an improving infrastructure and significant economies of scale. Furthermore, this will allow Croatia to develop as a regional player and act as a role model for other Western Balkan states.