

# BTI 2008 | Croatia Country Report

<b>Status Index</b>	1-10	<b>8.57</b>	# 14 of 125	
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scale: 1 (lowest) to 10 (highest)    score    rank    trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

The BTI is a joint project of the Bertelsmann Stiftung and the Center for Applied Policy Research (C•A•P) at Munich University.

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Please cite as follows: Bertelsmann Stiftung, *BTI 2008 – Croatia Country Report*. Gütersloh: Bertelsmann Stiftung, 2007.

## Key Indicators

Population	mn.	4.4	HDI	0.85	GDP p.c.	\$	11,603
Pop. growth <sup>1</sup>	% p.a.	0.0	HDI rank of 177	44	Gini Index		29.0
Life expectancy	years	76	UN Education Index	0.90	Poverty <sup>3</sup>	%	<2
Urban population	%	56.5	Gender equality <sup>2</sup>	0.60	Aid per capita	\$	28.2

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

## Executive Summary

During the review period, Croatia made further progress in transformation toward democracy and a market economy. The country intensified its Euro-Atlantic integration, whereby substantial reform efforts were clearly aimed at EU integration. The Sanader government's willingness to cooperate with external participants through the International Criminal Tribunal for the former Yugoslavia (ICTY) turned out to be a crucial breakthrough in relations with Brussels, facilitating the start of official accession negotiations with the European Union in October 2005. At the same time, Croatia made some progress in its relations with NATO; in late 2006, the United States signaled that Croatia might receive an invitation for membership as early as 2008. Croatian political institutions and the party system are now stable. The last two coalition governments under Racan and Sanader contributed to a less polarized party system. In particular, basic institutional conditions improved, and the dialogue with the EU Commission and regular reporting on progress in the accession negotiations that began in October 2005 resulted in improvements to constitutional legality and the protection of minorities. However, ethnic-based discrimination persists, and the judiciary is not sufficiently independent, impartial and professional. It also has yet to eradicate corruption. Public administration continues to be subject to political influence. Croatia's political leadership made strides to achieve reconciliation and regional cooperation in the Balkans, thus improving the country's reputation. This is reflected in the favorable investment climate and increased foreign direct investment. Croatia has also advanced economic transformation, showing continuous macroeconomic stability – apart from high foreign debt. Relatively high levels of unemployment, general government and trade deficits, slow sectoral change and an insufficiently competitive economy remain major problems. Croatia has successfully led accession negotiations that led to five chapters being opened. The announced aim to complete all the remaining chapters by the end of 2008 thus seems realistic. Intensified

reform efforts – especially in terms of protecting agriculture and the environment – are needed to achieve this objective. There is overall agreement across all parties on the strategic goal of integrating into the European Union as soon as possible. This goal is unlikely to change in the future. Parliamentary elections to be held in 2007 provide the opportunity for Croatia to demonstrate its ability to set up a new government in a timely fashion. Should it fail to do so, Croatia risks losing ground in EU accession negotiations, which could delay its final entry date into the European Union.

## History and Characteristics of Transformation

Until its independence, the Republic of Croatia was a constituent republic within the Socialist Federated Republic of Yugoslavia. Independence was formally declared on 25 June 1991. Before that, the Croatian Democratic Union (HDZ, Hrvatska Demokratska Zajednica), captured a majority of votes in elections held in May 1990. Franjo Tudjman, chairman of the party and a former general and nationalist dissident during Tito's reign, became the first president of Croatia. The task of establishing a new state – the new constitution was passed on 22 December 1990 – was accompanied by transformation toward democracy and a market economy. Ravaged by war, Croatia suffered a serious crisis that was accompanied by a decrease in industrial production of about 50% and a rapid increase in unemployment. Until the mid-1990s, up to 30% of its territory was occupied by rebellious Serbs; as a result, key linkages between the capital, Zagreb, and Slavonia and sections of the Dalmatian coast were disrupted, some even severed. During this period, democratization advanced only haltingly. Under Franjo Tudjman's authoritarian leadership in the latter half of the 1990s, the country grew increasingly isolated – both politically and economically – as the military regained control of formerly occupied areas in western Slavonia and the Krajina and the leadership proved unwilling to cooperate with international organizations. Consequently, Croatia remained one of the few transformation countries in Central and Eastern Europe not participating in NATO's Partnership for Peace program and without established institutional relations with the European Union by 2001. Reforms in the 1990s made some gains in advancing a market economy, despite difficult structural conditions. The foundation for a market-based economic framework was finally formed in the fall of 1993 with the establishment of a private property regime and the macroeconomic stabilization program. Inflation was also brought under control with the help of restrictive loan, finance and income policies. On the microeconomic level, reform policies aimed at developing and strengthening the private sector were less successful. Privatization proceeded in the context of an inconsistent stop-and-go policy against the backdrop of political power struggles. Foreign capital inflows were discouraged by minimal transparency in ownership conversions and preferences for insiders, resulting in insufficient restructuring and modernization of the business sector.

This, in turn, led to a minimally competitive export economy and rising trade deficits. Tudjman's death ushered in a period of great uncertainty. The governing HDZ suffered a devastating loss in the parliamentary elections of January 2000, which resulted in a change in the country's political direction. The left-center coalition government, consisting of six parties, was now led by the social democrats (SDP), who won a majority and elected the new premier, Ivica Račan. Transformation policies in Croatia thus changed as well. The constitutional amendments of November 2000 and March 2001 introduced a parliamentary system of government, ending the system of a dual executive and the powerful position of the president. Gains made in democratic transformation have been closely connected to increased cooperation with external actors such as the European Union, the WTO, CEFTA, the IMF and the World Bank. The European Union has acknowledged the fast pace at which Croatia had been able to facilitate economic and democratic transformation by signing the Stabilization and Association Agreements and offering the prospect of accession. These positive developments continued even after parliamentary elections in November 2003, which brought in a new government. The newly reformed HDZ regained the majority and elected Party Chairman Ivo Sanader the new prime minister. By early 2003, Croatia had made sufficient progress to officially apply for European Union membership. Following the Commission's positive response, the country was awarded candidate status in the summer of 2004.

## Transformation Status

### I. Democracy

Croatia continued to progress in the direction of democracy and to approach the standards of the European Union during the period under review. Due to the reform politics and the pro-European orientation practiced by Prime Minister Ivo Sanader and his predecessor, the country's accomplishments now seem to be recognized. By virtue of these politics, the EU Commission already considered Croatia to be a functional democracy in 2004, and the latter therefore became an official candidate for membership. However, the EU postponed accession negotiations with Croatia because the Croatian government did not fully cooperate with the International Criminal Tribunal for the Former Yugoslavia. In particular, the government did not undertake sufficient efforts to seize and extradite the retired army general and former wartime military leader Ante Gotovina who was accused of war crimes. In the autumn of 2005, the European Union considered Croatia's cooperation sufficient to open accession negotiations.

#### 1 | Stateness

Since 1998, after the eastern parts of Slavonia had been integrated, Croatia has extended the state's monopoly on the use of force, which is free from any limitations, over the entire national territory.

Monopoly on the use of force

All citizens have the same civic rights, and the majority acknowledges the constitution in principle. The constitution of 2001 defines Croatia as the nation-state of the Croatian nation and the state of members of ten specified national minorities as well as "others." Ethnic Serbs represent the largest minority, comprising more than 4.5% of the population in 2001, although this group amounted to 12% in the former Yugoslavia. Of the 300,000-350,000 Croatian Serbs who were involuntarily displaced as a result of the 1991-1995 war, approximately 120,000 refugees and displaced persons had registered their return to Croatia on 30 April 2006. Persistent difficulties concerning access to housing, acquired rights and employment have prevented many Croatian Serbs from returning. National minorities are still generally perceived in the media as separate entities and not as an integral part of society. Negative stereotyping in

State identity

the press has continued.

Deeply rooted within Croatian society and culture, the Catholic Church is seen as an identity-creating institution. Nevertheless, state and religion are separate to the greatest possible extent; political processes are secularized. However, in some questions – such as forbidding work on Sunday – the church strongly expresses its opinion with the aim of influencing public opinion.

No interference of religious dogmas

Public security and order are ensured. The state is present with basic administrative structures throughout the entire territory.

Basic administration

## 2 | Political Participation

There are no constraints on free and fair elections, as was illustrated by the last two parliamentary elections (2000, 2003) and the presidential election in early 2005, when President Mesic was re-elected for a second term. The presidential election was accompanied by some irregularities, mainly out-of-country voting, particularly in Bosnia and Herzegovina, and cases of double voting, where the same person voted once in Croatia and once in Bosnia and Herzegovina. These irregularities seem to have been caused by deficiencies in the voting procedure and the management of voter lists. For example, the diaspora voter list and the voter lists of the constituencies were not compared with each other. Due to allegations of mandate “selling” connected with the municipal elections in the spring of 2005, elections had to be repeated in several places. Clear and transparent rules and procedures for local elections and the formation of local self-administered governments are lacking. As the voter lists were based on the 2001 census and did not reflect the increase of minority residents in return areas since then, the Serb minority in particular remained underrepresented in municipalities. In March 2006, parliament adopted a law establishing a State Electoral Commission as a permanent body.

Free and fair elections

The elected government has a monopoly on the power to govern; the public does not accept interference by actors with veto powers, including military-based political enclaves. Individual lobbies and radical parties have lost popularity in society. The demonstrations organized by Croatian veteran federations against the arrest of General Gotovina in the fall of 2005 did not develop into a national protest movement. While the army is under civilian control, the counter-intelligence agency violated journalists’ human rights in several cases. To strengthen democratic supervision of the secret service, parliament adopted a law in June 2006. There are reports of links between organized crime and the police.

Effective power to govern

Within the framework of the democratic order, freedom of association and assembly are approved. Trade unions actively participate in the work of the

Association / assembly rights

tripartite Economic – Social Council and take part in consultation procedures on key strategic decisions.

Freedom of opinion and the press are subject to some intervention that undermines democratic principles, but outright press censorship is limited to a few isolated cases. Events at the end of 2005 and during the first half of 2006 indicate that media freedom continues to be challenged by some political forces, particularly when journalists raise politically sensitive topics linked to the 1991–1995 conflict. Journalists at the state-owned Croatian Radio and Television Company (HRT) were criticized by politicians for their managerial and professional omissions. Some of these journalists were sanctioned for alleged professional mistakes. In December 2005, the editor of a television program was dismissed by the HRT program council after Croatian Democratic Union members had attacked the program for its critical assessment of former President Tudjman’s legacy. The procedure for the appointment of the steering committee of the state news service HINA suffered significant shortcomings. National media outlets based in Zagreb are relatively independent, while local media remain exposed to varying levels of pressure from local authorities, many of whom co-own local media outlets. Local politicians and strongmen frequently sue journalists for libel. In June 2006, parliament approved amendments to the criminal code, abolishing prison sentences for libel.

Freedom of  
expression

### 3 | Rule of Law

Since constitutional changes were made in November 2000 and March 2001, the delimitation of competences between the executive, legislative and judiciary has been improved. As has been confirmed recently by the report of the EU Commission (November 2006), there are in principal no limitations on the basic functioning of the separation of powers. The government, however, may still dissolve local and regional self-government units without any prior judicial review by referring to their alleged illegality or unconstitutionality. Insufficient government support, including budgetary support, to the ombudsman’s office and the constitutional court continues to constrain their effective operation.

Separation of  
powers

The judiciary operates relatively independently, but Croatia is still some distance away from enjoying an independent, impartial and transparent judicial system. Judicial appointments are still frequently based on political suitability rather than professionalism. A uniform, objective and transparent assessment of judges and judicial trainees (such as a competitive examination and/or interviews) does not exist. Corruption is publicly perceived as endemic to the judiciary. Economic and other interest groups continue to exert influence on the judiciary, and judicial decisions are often tainted by an ethnic bias against Serbs. Based on an increased number of complaints in 2005, the ombudsman has warned that the government

Independent  
judiciary

does not take sufficient action to improve the quality of judges' work and to ensure their impartiality and independence against political interference and corruption. Due to overloaded courts, it takes a long time until a case is finally heard. The judiciary's operable efficiency is limited and needs to be improved, among other things by reducing the backlog of cases the length of court proceedings and by training judges. In April 2006, parliament adopted the National Anti-Corruption Program for 2006 – 2008, which includes measures to combat corruption in the judiciary.

Generally speaking, corruption, clientelism and nepotism continue to be serious problems in Croatia. For instance, the current deputy prime minister was alleged to have acquired a flat in downtown Zagreb for a price far below its market value from the Ministry of Defense during the Tudjman era. The public perception of corruption deteriorated in 2006. No high-profile cases of corruption had been successfully prosecuted as of March 2007. Because corruption is seen as a strong obstacle to the process of EU integration, the fight against corruption has been given high priority. Over the last few years, the media put more efforts into uncovering office abuses. However, many allegations of corruption remain uninvestigated and corrupt practices usually go unpunished. To some extent, investigative committees in parliament appear to be used as a political tool rather than a serious instrument to address conflicts of interest.

Prosecution of  
office abuse

The level of protection against discrimination is, according to the EU Commission, still far from EU standards. Ethnically motivated attacks have been reported continually in the review period, and they were mostly aimed against the Serb minority and the Orthodox Church. One attack resulted in the victim's death. The police and judiciary have not sufficiently investigated and prosecuted such incidents. While top officials have quickly condemned some incidents, notably the Biljane Donje incident in July 2006, especially local politicians and media often do not clearly condemn ethnically motivated violence. Ethnic Serb returnees and those who remained in Croatia during the war still face major difficulties regarding access to employment, especially in the war-affected areas. Persons belonging to minorities are underrepresented in the civil service, the police force and the judiciary, although the 2002 constitutional law on national minorities envisages an equitable representation of these groups in public institutions. Minorities are still not treated equally in property-related and economic matters. The OSCE High Commissioner on National Minorities has repeatedly expressed concern regarding the physical separation of Croat and Serb schoolchildren in eastern Slavonia. The vast majority of war crimes are still tried in the community where the crime occurred, raising concerns related to witness security and impartiality. Witnesses of major war crimes often refuse to participate in Croatian proceedings due to security concerns, fearing the repetition of an incident in late 2005 when the right-wing extremist mayor of Osijek

Civil rights

publicly read out a list of potential witnesses in an important war crimes case. In 2006, the ombudsman reported to parliament on overcrowding and sub-standard conditions in Croatian prisons and found that complaints about improper police conduct doubled from 2000 to 2005. The counter-intelligence agency violates the civil rights of journalists through its surveillance and interrogation activities.

#### 4 | Stability of Democratic Institutions

During the period under review, democratic institutions in Croatia can be described as stable and working in accordance with their purposes. In other words, political decisions are prepared, met, executed and controlled by the appropriate institutions. To this end, the two constitutional changes in 2000 and 2001 have primarily contributed to this issue. These amendments contained – among other things – the abolishment of presidential decision-making bodies in favor of the parliament, thus eliminating insecurities concerning the separation of powers. Improvements within this domain can also be attributed to the gradual alignment of Croatia’s institutional framework to EU standards as Croatia moves toward compatibility with the European Union. However, the judiciary and public administration remain the two key challenges. Although the first steps have been made in the right direction, Croatia is still in an early stage of reforming its judiciary and public administration. The ombudsman warned that the current practice of filling administrative posts with politically suitable staff negatively affects the professionalism and continuity of the state administration. The wide discretionary scope in legislation leads to inefficiency and legal uncertainty.

Performance of democratic institutions

Democratic institutions are accepted by all relevant political and social participants and are regarded as legitimate. The right-wing extremist party, Croatian Party of Rights (HSP), increased its representation in the local and regional elections held in May 2005, particularly in war-torn areas.

Commitment to democratic institutions

#### 5 | Political and Social Integration

A pluralistic party system has been in existence since the beginning of 2000. In 2001, 75 parties were registered, 14 of which were represented with at least one delegate in the Croatian parliament (Sabor). Over the last few years and in particular since 2003, the dissipation of existing parties and foundation of new parties came to a close. Therefore, a strengthening of the party system was achieved in the period under review. Admittedly, the Croatian party system is still characterized by a medium to high degree of fragmentation and a moderate level of voter volatility. Nevertheless, the last two coalition governments showed a moderating effect on the polarization of the party system. Limited program capability and weak social integration can often be observed. In fact, only a few

Party system

parties – such as the Croatian Peasant Party (HSS) – have a long tradition and are anchored in society. In addition, some parties are one-sided in their orientation toward their regional constituencies, such as Istrian Democratic Assembly (IDS).

The network of interest groups has become more closely knit in the last three years, and a willingness to cooperate and mediate between society and the political system exists in embryonic form. In the review period, the significance and autonomy of trade unions increased.

Interest groups

The population's approval of democracy is medium to high. Political protests target those currently in power and do not challenge the institutional framework as a whole.

Consent to democratic norms

While there are 29,672 registered associations in Croatia, over 70% focus on sports, cultural, economic, technical and war veterans' issues. Few NGOs are involved in human rights or other advocacy matters. The NGO sector is not yet consolidated, and few NGOs are professionally staffed or have appropriate budgets.

Associational activities

## II. Market Economy

Although the reform dynamic for market transformation is weaker than the progress in democratic reforms, Croatia has registered continuous economic growth for the last few years. This is mainly due to the strong rise in domestic demand and clearly improved institutional conditions. In this context, the consolidation of the banking sector, the intensification of the privatization process as well as the more favorable investment climate play a crucial role in the run-up to the forthcoming EU integration. In the meantime, a set of indicators such as economic growth, GDP per capita and inflation, Croatia already has the same or even higher marks than some of the new member states of the European Union. The EU considers Croatia to be a functioning market economy that may be able to cope with the competitive pressure of the EU in the medium term so long as reforms continue at the same pace.

### 6 | Level of Socioeconomic Development

With a GDP per capita of 6,968 euros in 2005 (Croatian National Bank), Croatia is the highest-income country in southeast Europe and – besides Slovenia – the second wealthiest successor state to former Yugoslavia. The Human Development Index (HDI) ranks Croatia 44th with an index value of 0.846, showing a favorable trend over the last few years. Social exclusion is

Socioeconomic barriers

quantitatively and qualitatively limited and not significantly ingrained structurally. Also, the Gini coefficient of 0.29 as measured by the HDI 2004 represents only moderate social disparities. Yet regional disparities exist and especially war-torn areas like Lika and eastern Slavonia still suffer economic disadvantages. Gender discrimination is not apparent; the United Nations Development Program's Gender-related Development Index 2004 ranks Croatia 40th out of 144 countries with an index value of 0.848. The government prepared a joint inclusion memorandum in 2006. According the World Bank report on living standards, poverty in Croatia is quite limited.

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	23,046	29,609	35,262	<b>38,506</b>
Growth of GDP	%	5.6	5.3	3.8	<b>4.3</b>
Inflation (CPI)	%	1.7	0.1	3.7	<b>3.3</b>
Unemployment	%	14.8	14.3	13.8	-
Foreign direct investment	% of GDP	4.9	6.9	3.5	<b>4.6</b>
Export growth	%	1.2	11.4	5.4	<b>4.6</b>
Import growth	%	13.4	12.1	3.5	<b>3.5</b>
Current account balance	\$ mn.	-1913.6	-2141.9	-1841.5	<b>-2585.0</b>
Public debt	\$ mn.	7,679.3	10,062.1	11,596.3	<b>9,782.0</b>
External debt	\$ mn.	16,682.4	25,736.2	32,915.0	<b>30,168.6</b>
External debt service	% of GNI	17.8	15.2	15	<b>13.2</b>
Cash surplus or deficit	% of GDP	-3.6	-4.0	-3.9	<b>-2.8</b>
Tax Revenue	% of GDP	24.9	24.1	23.4	<b>23.3</b>
Government consumption	% of GDP	21.6	21.0	20.3	<b>19.7</b>
Public expnd. on edu.	% of GDP	4.5	4.7	-	-
Public expnd. on health	% of GDP	5.8	6.1	6.2	<b>6.1</b>
R&D expenditure	% of GDP	1.1	1.1	-	-
Military expenditure	% of GDP	2.1	2.1	1.7	<b>1.6</b>

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

## 7 | Organization of the Market and Competition

Basic conditions of market competition – such as price determination, freedom of pricing and free use and transfer of profits – are guaranteed. Despite the progress that has been made, however, institutional rules are sometimes applied with inconsistency and non-uniformly to market participants.

Market-based competition

Despite the expansion of the national antitrust division's (AZTN) responsibilities in 2003, it has not been possible to proceed more effectively against monopolies and oligopolies within the framework of the anti-trust laws. This is due to insufficient resources, which result in considerable reductions in its scope of action. However, as a result of implementing the Stabilization and Association Agreement (SAA) and making necessary adjustments to fulfill the *acquis communautaire* starting in October 2005, the Croatian government now gives more attention to this topic. In this context, due to technical and financial assistance on the part of the European Union, small improvements can already be seen. The European Union also expects further reductions of Croatian national subsidies for large enterprises, in particular in the shipbuilding industry. Further progress has been made in enhancing competition in the telecommunication sector. Initial steps have been taken to restructure the loss-making railway system, while the restructuring of the shipbuilding as well as the iron and steel sectors remain priorities. Overall, institutional capacity needs to be strengthened, and further steps need to be taken to meet the conditions of the *acquis communautaire*.

Anti-monopoly policy

To a large extent, trade with the European Union was already liberalized as a result of the Stabilization and Association Agreement, and existing special arrangements will be abolished gradually in the course of accession negotiations with the European Union.

Liberalization of foreign trade

Since the financial crisis in the late 1990s and the subsequent consolidation of the banking sector, the Croatian banking system ranks among the most efficient in the region. Over 90% of bank assets are now held by foreign banks, most of which are based in EU countries such as Austria and Italy. Croatia's financial system is stable and competitive. A new supervisory agency for the non-banking financial sector has been established. The insurance sector is small but competitive. The stock exchange has been growing rapidly, and securities markets are open to foreign investors.

Banking system

## 8 | Currency and Price Stability

Croatia has been extremely successful in keeping inflation relatively low for many years. During the period under review, a consistent inflation policy was continued. Therefore, inflation was registered at a relatively low level of 3.3% in 2005. In accordance with its main goal of price stability, the Croatian National Bank has implemented an exchange-rate regime of managed floating. Excessive exchange-rate fluctuations are prevented by occasional market interventions, keeping the fluctuation of the kuna to the euro in a narrow band of 6% around the average exchange rate.

Anti-inflation /  
forex policy

Those who expected the 2003 change in government to trigger a modification in exchange-rate policy and a devaluation of the Croatian currency were clearly disappointed. Until today, the kuna has remained invariably strong. On the one hand, this might impair Croatian exporting industries, but on the other hand, reliability of expectations can be guaranteed for all participants. Most likely, this is due to the strong and independent position of the Croatian central bank (HNB), which has cooperated closely with the IMF over the last few years. In September 2005, the first review of the stand-by arrangement was completed. On this occasion, the IMF Executive Board confirmed that most of the quantitative performance criteria were met. There was a rise in foreign exchange reserves during the review period. Simultaneously, an end was finally brought to the enormous increase in external debt. However, at more than 80% of GDP, external debt remains at an extremely high level. Fiscal performance has been broadly in line with policy targets set in the Pre-accession Economic Program (PEP) 2005 and agreed upon under the current IMF program.

Macrostability

## 9 | Private Property

In principle, property rights and the regulation of the acquisition of property are well defined, although state intervention and ownership are still significant. Privatization continues albeit slower than envisaged. Over the last few years, existing deficits were successfully tackled; the revision and digitization of the land registers in 2005 especially contributed to substantial improvement in this area. Thus, existing uncertainties concerning property rights were eliminated to a great extent.

Property rights

Institutionally speaking, private companies are viewed as the primary engines of economic progress and are thus given appropriate legal safeguards. After a slow and inefficient privatization period in the 1990s, the process clearly sped up over the past few years. By now, over two thirds of the Croatian economy have already been privatized. Moreover, there has been a new wave of privatization in recent

Private  
enterprise

years, attracting far more strategic investors and leading to higher FDI inflows. Larger projects, such as the privatization of the largest Croatian enterprise INA, which was postponed several times, was accomplished during the review period. Furthermore, other considerable transactions are still pending. In this context, the European Union acts as a motivator for making progress in restructuring and partially privatizing the largest Croatian shipyards and the steel industry. Sectoral change is slowly progressing. State aid remained high, largely supporting specific sectors, such as shipbuilding, steel, aluminum and railways. Overall, state intervention in the productive sector remains significant.

## 10 | Welfare Regime

Social security systems, which traditionally played an important role in Croatia, became less important with the collapse of the old social order and the transformation crisis in the early 1990s. However, during the course of economic recovery, these systems regained importance and have even been expanded. Social networks are well developed in part but do not cover all risks for all strata of the population. Some groups are still at risk of poverty. Facing 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 other European countries by establishing individual accounts and offering private investment options for a portion of the funds.

Social safety nets

A number of institutions compensate for gross social differences albeit insufficiently. Clientelist practices, politicization and ethnic bias against minorities constrain the equality of employment opportunities in the public sector. The level of protection against discrimination and its judicial prosecution is still not in line with EU standards. Other risks associated with poverty remain for some sections of the population. The high unemployment rate, although declining, represents of course a burden on social insurance systems. Croatia made some progress with the Joint Inclusion Memorandum (JIM) adopted in 2006, but much remains to be done to combat social exclusion. There have also been positive developments in the field of equal opportunities. Women have equal access to higher education and significant access to public offices and accounted for 21.7% of parliamentarians in 2006. In October 2006, the Croatian government adopted the National Policy for the Promotion of Gender Equality 2006-2010.

Equal opportunity

## 11 | Economic Performance

GDP growth has been relatively high over the last years, with a GDP per capita of 6,968 euros in 2005, and is associated with positive or controllable

Output strength

macroeconomic data. In the first half of 2006, the real growth rate was 4.8%, and due to private investment, economic activity remained strong in the third quarter. Even though the growth rates point to the Croatian economy's catching-up process, other indicators underline the fact that the transition process in Croatia is far from being completed. In spite of significant growth rates, GDP could exceed the pre-war level of 1990 only recently, so that catching up with EU members as well as competitiveness remains the biggest challenge in the near future. The high trade deficits put a strain on the Croatian economy. High import levels are not the result of purchasing investment goods, which would help foster future domestic performance, but rather of purchasing consumer goods. Exports remain highly concentrated, pointing to more diversification and thus development of industrial structures. The current account deficit widened until 2002, driven by a continuously increasing trade deficit that then declined in 2004. In the last few years, the unemployment rate has slowly declined, but at a 2005 rate of 13.5%, unemployment continues to be one of the most pressing problems, particularly as the share of long-term unemployment is increasing, accounting for 54% of total unemployment. In light of forthcoming EU integration, improved regional cooperation within the Stabilization and Association Agreement, the integration of the Western Balkans into the common free trade zone CEFTA, further restructuring in the enterprise sector and the increasing inflow of FDI, the Croatian economy's growth potential can be classified as favorable. Credit growth, a stimulus for domestic demand, is weakening, so other engines of progress need to be activated. Whereas the service sector – especially tourism – has been performing successfully over the last few years, the development of a more modern and internationally competitive industrial sector is needed. This can be achieved with a stronger orientation toward innovation and research and development.

## 12 | Sustainability

Even though environmental awareness in Croatia has traditionally never been particularly developed, receptiveness for environmental issues has risen over the recent years, both among the general public and the legislative bodies. In the review period, several organizations were founded – among them the Eco-Social Forum – that fight for greater attention to aspects of sustainability in the Croatian society and economy. Environmentally compatible growth is increasingly taken into account in important portions of economic life, but it still tends to be subordinated to growth efforts. A positive exception is tourism, which capitalizes on ecologically compatible growth to enhance existing comparative advantages among competing tourist destinations. Croatia has ratified the Cartagena Protocol on Biosafety, the Framework Convention on Climate Change and the Convention on Biological Diversity, as well as signed the Kyoto Protocol. Also, Croatia

Environmental  
policy

adopted a national environmental action plan before starting the negotiation process with the European Union. Responsibilities are clearly assigned to the Ministry of Environmental Protection, Physical Planning and Construction. The commercial sector also competes by underlining its commitment to ecologically sound growth. Croatia has made progress in the area of air and water quality, waste management and nature protection, but there has been little or no progress in industrial pollution and noise. Positive tendencies are likely to intensify as the country adopts EU standards.

Both public and private institutions for education and training are relatively strong and in some cases quite advanced. At 4.5% of GDP in 2005, investment in education and training is average quantitatively and qualitatively. Croatia's educational structure mirrors the distribution in most Central and East European countries; the largest group is comprised of individuals with intermediate education levels, and the share of people with higher education is substantially below the EU average. Since 2004, the Ministry for Science and Education (MZOS) has been trying hard to mitigate the considerable brain drain and increase the share of highly educated people among the population, which – according to official information (Republic of Croatia 2006) – ranges below the EU average at approximately 12%. The program Unity Through Knowledge, initiated with World Bank support, seeks to foster this aim by connecting the academic diaspora with domestic researchers. Furthermore, well-established researchers from around the globe will be given the opportunity to return to their home country. Investment in R&D (1.28%) has been significantly below the EU average so far. Over the course of further integration and accession negotiations, however, some successes have emerged, as can be concluded from the latest reports by the EU Commission. In 2006, an initiative was started together with Croatia's academic community in order to advance cooperation between businesses and science. The adoption of the Strategic Development Framework 2006 – 2013 could be a step forward in meeting the goals of the Lisbon Strategy and a knowledge society.

Education policy  
/ R&D

## Transformation Management

### I. Level of Difficulty

Structural limitations during the review period were moderate, despite some challenges related to specific structural constraints.

Structural constraints

Society is still struggling with the legacy of authoritarian political structures, especially concerning the people's trust in state institutions. Civil society traditions may be evaluated as moderate. Sometimes NGOs are viewed with suspicion by the establishment.

Civil society traditions

Reinforced minority rights and the pursuit of increasingly prudent politics have eased ethnic tensions since 2000. However, ethnically based discrimination persists, and returning ethnic Serb refugees still face hostility, particularly in Krajina or eastern Slavonia. The media continue to create negative stereotypes of national minorities.

Conflict intensity

### II. Management Performance

#### 14 | Steering Capability

During the review period, there have neither been parliamentary nor presidential elections in Croatia. Therefore, the discussion below considers the achievements of the Sanader government, which was elected in November 2003. The government is led by the Croatian Democratic Union (HDZ) and dependent on the pensioners' party (HSU), the Democratic Center (DC), the Croatian Social-Liberal Party (HSL) and representatives of national minorities. President Mesic was reelected on 16 January 2005. EU integration has been the Sanader government's highest priority since its takeover of power; all other goals are considered subordinate. After the accession negotiations had finally started, Sanader's government was eager to make up the time lost between March and

Prioritization

October 2005 and focus its attention on issues like the reduction of government expenditures, subsidies and the enforcement of an increasingly competitive framework. In addition to public administration and the judiciary, this has implications for all areas in which – according to the EU Commission – Croatia shows significant deficiencies, especially in tackling corruption. In 2006, an initiative was started together with the academic community in Croatia to facilitate cooperation between businesses and science. Within the 2006 Strategic Development Framework (2006 – 2013), the government has chosen knowledge, education, research and strengthening human resources as the areas highly important to further development as. The National Scientific and Technological Policy sets out both short-term and long-term strategic aims, establishes a new financing mechanism, and defines new rules and procedures for individual research grants and existing research programs. By stimulating export activities and restructuring large Croatian companies owned by the state, the government is focusing on higher competitiveness of the Croatian economy on the global market, with a positive effect on Croatia's foreign debt and balance of payments deficit.

Implementation of the Stabilization and Association Agreement (SAA) has largely continued without major difficulty. Greater progress has been made in the area of infrastructure, especially concerning the upgrading of the highway network. By 2007, the network will have been extended to 800 kilometers altogether – meaning a significant competitive advantage compared to other countries in the region. Simultaneously, the single regions of Slavonia, Istria and Dalmatia will be connected with the country's center and the capital Zagreb, and the southern parts will be more easily accessible to tourists.

Implementation

At the beginning of 2006, Sanader proved that he is also able and willing to learn. Instead of immediately rejecting Brussels' proposal to found a new free trade area named "Western Balkans," as might have been expected, he made a constructive alternative proposal. His suggestion to enlarge the existing CEFTA by integrating the countries of the Western Balkans found EU support quickly, and thus, Zagreb proved its willingness to take an active role in forming the region and demonstrated diplomatic maturity.

Policy learning

## 15 | 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, budget deficits (5.2% of GDP in 2004) and state indebtedness, exceeding 80% of Croatia's GDP, are persistent. Although it has been announced, significant reform of the country's health system has yet to be undertaken and completed. In other areas, the country's managers have been

Efficient use of assets

more successful, especially concerning the decentralization of administration. Local organs of self-administration have been granted more legal and financial autonomy in recent years. Bureaucratic barriers to business activities have been diminished. Following long discussions, the government established HITRO, a program aimed at reducing red tape and improving regulatory quality. The introduction of the HITROREZ program in 2005 will help reduce the bureaucracy involved with the regulation of economic activity. Finally, the time needed to start a business has been shortened, which has improved the investment climate. Government administration needs to be more efficiently organized according to principles of professionalism. The new Civil Service Law came into force in January 2006. This law addresses deficiencies in the legal status of civil servants and other public employees, most notably with regard to the de-politicization of public administration, recruitment, selection, promotion and training policies. It also covers the regulation of possible conflicts of interest as well as – to a certain degree – the need to reduce the number of political appointees in the public administration. Whether or not the law will lead to an effective de-politicization of public administration depends on the future adoption and implementation of legislation. Since the de-politicization clauses will only take effect after the 2007 parliamentary elections, Croatia's civil service remains dependent on political affinities. Even new appointments are not protected against partisan political influences. The composition of the different task forces in context of EU accession negotiations may serve as an example of emphasizing competence rather than party affiliation. Yet the supply of skilled and well-educated staff is scarce, leading the government to try, increasingly, to integrate the highly-qualified Croatian diaspora in the areas of economics, science and public administration. There are first signs of success emerging from the Ministry of Science, Education and Sports' efforts to build networks and synergies by sponsoring events and developing contact databases. The judicial system has continued to suffer from slow and inefficient court proceedings, poor case management and low administrative and professional capacity. Corruption remains a serious problem as along with weaknesses in recruitment and human resources management.

The government tries to coordinate conflicting objectives and interests, but it has only limited success. Intra-governmental friction, redundancies and lacunae are significant. The high level of centralization is still a burden, as is the existing legal administrative system with its wide margins of discretion.

Policy coordination

Although the government seeks to provide all integrity mechanisms, efforts to fight corruption remain behind both domestic and EU targets. In March 2006, the Croatian government adopted the new National Anti-Corruption Program, including a wide range of sectoral action plans and the strengthening of the Office for Prevention of Corruption and Organized Crime (USKOK). In October

Anti-corruption  
policy

2006, the Croatian parliament appointed a national council composed of members of parliament and trade unions, academics, media and NGOs dealing with the issue of corruption to monitor the development and effective implementation of the Anti-Corruption Program. The question of financing of election campaigns is not included in the legislation.

## 16 | Consensus-Building

There is a consensus on the need to build democracy and a market economy among all major political actors, including Premier Sanader, President Mesic and all representatives of the Sabor parties. This was confirmed by a meeting of the Croatian parliament as early as 2002, when the Alliance for Europe was established through a consensus among all parliamentary parties to support EU membership as a strategic objective of the country. Therefore, there were no significant surprises when the government changed at the end of 2003 and the reformed Croatian Democratic Union (HDZ) took over, and no surprises or major changes are expected to result from the parliamentary elections at the end of 2007. The responsible persons have consequently been aiming at integration into the European Union and NATO and have made some progress, reflected by the start of accession negotiations at the end of 2005 and the prospect of NATO membership in 2008. Encompassing representatives of all parliamentary parties, trade unions, employers' unions and academia, and with the former Minister for EU Integration Neven Mimica as head, the National Committee for Following the Accession Negotiations continues its regular meetings.

Consensus on goals

Antidemocratic forces have lost their influence; both extremist and anti-European parties have been marginalized. This was clearly underlined by reactions to the *causa Gotovina* in the summer and fall of 2005. Despite individual protests, the countrywide mass demonstration announced after the Croatian general's arrest failed to take place and thus could not put destabilizing pressure on the Sanader government and the track to Europe.

Anti-democratic veto actors

Both President Mesic and the government demonstrated a conciliatory attitude toward ethnic minorities – underlined especially by their enlistment of the Serbian party SDSS into the government – a clear signal and call for social tolerance. Symbolic gestures and positive statements on reconciliation from senior state officials, mutual visits between leaders from both Croatia and Serbia, and events such as the celebration of the 150th anniversary of the birth of the Croatian Serb inventor Nikola Tesla have contributed to an improved atmosphere.

Cleavage / conflict management

While NGOs are still often viewed with suspicion by the establishment, the government and the wider public have been gaining a more positive perception

Civil society participation

of NGOs in the last two years. However, cooperation and professionalism within the sector is insufficient and NGO programs tend to be short-term due to financial constraints. Leading advocacy NGOs continue to be sustained by international donors. In July 2006, the government adopted a comprehensive legal framework and strategy aimed at creating a sustainable environment for civil society. In 2003, a Government Office for Cooperation with NGOs, a Council for Civil Society Development and a National Foundation for Civil Society Development were established. Cooperation between these new civil society institutions remains weak, and they have not yet fully defined their respective roles and responsibilities. Key legislation recognizing tax benefit status for NGOs, funds and foundations, transparent state financing of NGO activities, non-profit entrepreneurship and volunteer activities have been pending since 2003.

The political leadership recognizes the need to deal with Croatian war crimes, but the process of reconciliation has only been partial and fraught with ambiguities. Domestic war crime prosecutions have been characterized by ethnic bias against Serbs. The retrial of the Lora case at Split County Court in March 2006 led to the conviction of all eight former Croatian military policemen for war crimes against Serb prisoners of war. The court, however, continued the practice of taking the defendants' active involvement in the war into consideration as mitigating circumstances. While the Croatian government has cooperated fully with the International Criminal Tribunal for the Former Yugoslavia, prosecutors in Croatia have hesitated to raise charges against Rahim Ademi and Mirko Norac, two generals suspected of war crimes against Serb civilians who were transferred from ICTY to Croatian jurisdiction in September 2005. The European Parliament has expressed concerns that the effective prosecution of war crimes in Croatia might be undermined by hostility at the local level, persisting bias among some of the judicial staff against non-Croatian nationals and insufficient protection of witnesses against intimidation. Also, to date, it appears that nobody has been prosecuted in Croatia in connection with aiding fugitives indicted in absentia, nor does it appear that anybody has been prosecuted for aiding in removing traces of war crimes, nor for intimidating witnesses or revealing the identity of a protected witness. Since the arrest of Ante Gotovina, the Croatian government has indicated its willingness to support his defense, and various local authorities have also contributed financially to a fund established for the same purpose. It is perhaps indicative of the general mood that little is said in public discourse about the need to establish the truth about who is responsible for the crimes for which Ante Gotovina and other Croatian generals have been indicted. As elsewhere in the region, the general public does not have easy access to objective information about the work of the ICTY. The government has de facto prevented the recognition of pension claims by people who worked in the so-called "Republika Srpska Krajina" during the

Reconciliation

Croatian-Serb conflict, although this would be a tangible sign of Croatia's willingness to overcome the rifts left by the conflict and promote reconciliation in the country. More generally, Croat society has not yet come to terms with the crimes committed by the fascist Croat state during World War II. A nostalgic extenuation of this time prevails and has been promoted by Croatian pop stars such as Thompson.

## 17 | International Cooperation

In the last two years, the government has used numerous international programs and projects to foster reform efforts, especially concerning the improvement of the institutional framework, the enhancement of infrastructure and the decentralization of governmental administrative structures. Croatia was in a position to dispose of around 400 million euros in EU funds as part of the accession strategy and diverse programs such as PHARE, ISPA, SAPARD and CARDS; starting in 2007, Croatia will benefit from the new IPA program.

Effective use of support

After the European Union had suspended the start of accession negotiations due to Croatia's failure to fully cooperate with the ICTY, Croatia managed to start negotiations in October 2005. Croatia has also won some ground in its relations with NATO. In particular, its participation in the anti-terror coalition as well as Croatia's deployment of military forces to Afghanistan and Iraq contributed to this favorable development. Thus, President Bush indicated to the Croatian prime minister in the fall of 2006 that an invitation for NATO membership was likely. The international community especially appreciated the readiness of the Croatian government to contribute to reconciliation and cooperation within the region. This positively affected relations with Sarajevo and Belgrade, and also with Podgorica when Montenegro became independent in 2006. Consequently, Croatia is finally considered a stabilizing factor in the Western Balkans, both by the international community in general and the European Union in particular.

Credibility

Croatia actively participates in regional initiatives. In this context, the initiative and commitment to create a multilateral free trade agreement must be mentioned. The new CEFTA, signed on December 2006 and replacing the 32 bilateral free trade agreements in southeastern Europe, is considered an important step for economic development and preparation for membership in the European Union. Croatia presently chairs the Southeast European Cooperation process (SEECF) and will host the SEECF summit in 2007. It also actively participates in the Stability Pact, supports the establishment of the Regional Cooperation Council and has signed the Energy Community Treaty in Athens, which entered into force on 1 July 2006. Whereas the quality of relations with its southeastern European neighbors has been ameliorated, Croatia and its leaders could not ease tensions with its northern neighbor Slovenia. Problems remain

Regional cooperation

with the unresolved border disputes on land and at sea, and there are two open disputes over the Krsko nuclear power plant and (Nova) Ljubljanska Banka, resulting from the common Yugoslav history. The Croatian suggestion to resolve the argument with the help of a neutral third party has thus far been rejected by Slovenia. Both sides repeatedly provoke the other, most recently in January 2007, when Slovenian Prime Minister Rupel publicly mused about blacklisting Croatia as a tourist destination. Nevertheless, both sides avoid open escalation.

## Strategic Outlook

Over the last few years, Croatia's democratic consolidation and institutional stabilization have facilitated accession negotiations with the European Union, thus bringing the country closer to its goal of European integration. Ongoing cooperation with the European Union is particularly important as it provides access to the financial and technical assistance needed to establish an efficient and vibrant market-based democracy in Croatia. However, Croatia must intensify and expedite its own reform efforts – particularly structural reforms – to meet and prove capable of enforcing the *acquis communautaire*. Though accession negotiations have gone well to date, it is important to bear in mind that more drastic reforms, such as agricultural and environmental protection legislation, have yet to be initiated.

The European Union's reports on Croatia's progress document a successful start to accession negotiations and professionalism in screening and dealing with the first negotiated chapters. By the end of 2006, Croatia managed to open five chapters and close two of them, meaning that negotiations are likely to be concluded by the end of 2008. This in turn would mean that Croatia might become the 28th member before the end of the decade – and that Sanader would keep his promise. Despite existing reforms and partial successes, there are short- to medium-term strategic challenges in the areas of administrative structure, judicial administration and corruption. Stabilizing the framework for competition, dismantling subsidies and continued privatization appear to be just as urgent challenges. Although the private sector has grown, the state's share of the economy is still too high in several key industries. Accession negotiations will require that competition be enhanced further, that its commercial balance sheet improve, and that the standard of living in Croatia catch up with that found in most of the European Union. Though there are signs of improvement to Croatia's economic competitiveness, much more is needed if the country is to stand its ground within an EU market. Recently initiated programs such as "budimo CROativni ("be CROative"), as well as the recent export offensive, may be first important steps in this direction.

With investments in tourism increasing in recent years, the sector shows growth potential. To better exploit this trend, Croatia will need to improve the quality of tourism it offers, including better hotel resorts with expanded leisure-time facilities. Strategic foreign investors might play a crucial role here. Accession negotiations imply a reduced credit risk for investors and serve to attract foreign direct investment. Combined with macroeconomic stability, this should result in increasing foreign direct investment, which in turn will support the necessary

modernization process.

As parliamentary elections will be held in 2007, reform eagerness is likely to be eclipsed by the election campaign in the run-up to elections. Given the fact that there is overall agreement across all parties on the strategic goal of integrating into the European Union as well as NATO, the fundamental issues of the party or coalition forming the new government will pale in comparison. Setting up a new, stable government quickly so as to avoid losing time in the accession negotiations will likely take priority. A stable and well-functioning government will be extremely important in confronting painful but necessary reforms in the next few years.