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CROATIA

Stabilisation and Association Report

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1. EXECUTIVE SUMMARY

The political environment in Croatia changed radically with the advent of the new leadership early in 2000. The new Government has shown determination in its efforts to establish a fully fledged democracy and to develop a culture of respect for the rule of law. This and the steps taken so far have ended Croatia's political and economic isolation, leading to a rapid improvement of bilateral relations between Croatia and the European Union.

The Government now faces two main challenges: to consolidate democracy to underpin long-term political and social stability; and to implement a comprehensive programme of structural reforms to achieve political and economic transition. Success will require the commitment and active participation of all parts of the public administration. Civil society, too, will need to play a more effective role.

There has been a sea change in the approach of the current Government in the areas of democratisation, respect for human rights including minority rights and compliance with obligations under the Peace agreements. Considerable progress has been made. However, the most far-reaching potential threat to the achievement of economic, political and social reform is the continuing weaknesses of the judiciary and the resulting problems in law enforcement. Nationalistic pressures continue to have some impact on the pace of reform. This is particularly true for the return process, and de facto integration of the Serb minority. They have also been a factor in the handling of co-operation with ICTY. In addition, nationalistic pressures affect the attitude of the Government to increased regional co-operation. While at the bilateral, practical, level there have been important steps forward, there is a persistent tendency to over-politicise and over-estimate the impact of and intentions behind regional initiatives. Croatia needs finally to overcome regional and historical frictions and take a more open approach to addressing outstanding political questions with its neighbours.

Macroeconomic indicators show that the state of the economy is improving. The Government has begun the process of economic and structural reform. This is proceeding at a slower pace than expected, but tangible results are expected within the medium-term and already in the course of 2002. High unemployment remains a main concern.

The signature of the Stabilisation and Association Agreement (SAA) was an indicator of the steadily improving relationship between Croatia and the European Union. The credibility of Croatia's aspirations to become a candidate for EU membership depends in the first instance on how successfully it implements the SAA, which offers a clear route to bringing the country closer to European standards. The Agreement has had an immediate and concrete impact on the domestic reform programme. For instance, the Government is making serious efforts to establish the necessary legislative framework. However, the implementation of adopted legislation remains a major challenge and the administration needs to look at its own capacity to implement the reforms and address the deficits it finds. Although the Government appears to appreciate this, it continues to focus too much on the headline political objectives of Croatia's European policy rather than on the enormous effort that moving closer to European standards requires.

2. POLITICAL CRITERIA

2.1. Democracy and Rule of Law

Croatia is advancing steadily in the transition process. Overall the country is reasonably stable. A radical change of attitude of the new leadership and substantial progress in adjusting the legislative framework have contributed to a strengthening of the democratic environment and ensured a general respect for the rule of law. The Government is consistent in its efforts to implement a challenging reform agenda and to tackle the remaining shortcomings in order to meet the EU political and economic conditions. However, the pace of reform falters at times as a result of a lack of cohesion within the ruling coalition.

Democratic institutions work well on the whole. However, political dialogue between the government and the opposition remains difficult. Tendencies to radicalism remain in some of the opposition parties but do not meet with enough public support to be considered as a threat to stability.

The judiciary remains an area of particular concern, suffering from serious organisational problems, inefficiency of procedures, a lack of expertise and long delays in the conclusion of cases. Radical reforms are needed but no substantial progress has been made. This weakness directly impacts on implementation of the rule of law which remains problematic and uneven.

There are still problems in the return process, with the treatment and successful integration of Serb returnees continuing to cause concern.

2.1.1. Assessment of democratic institutions and attitudes to the state

Constitution. The revision of the Constitution in November 2000 moved Croatia from a semi-presidential system, which gave rise to abuses in the past, to a full parliamentary system. This has resulted in a positive reshaping of the relationship and the balance of power between the President, the Parliament and the Government.

Parliament. Parliament functions smoothly, and the abolition of the Upper House of Parliament has made a positive impact on the legislative process. In 2001 Parliament adopted more than 200 legislative acts, most of them by urgent procedure.

The Croatian Democratic Union (HDZ), the party of former president Tuđman, is the main opposition party and seems to have registered a relative rise in popularity over the last months. However, HDZ has not transformed itself into a true democratic party and a part of it has never clearly distanced itself from radical nationalism. The relationship between the ruling coalition and the opposition remains tense and based on confrontation.

The Governmental and Presidential political lines, in particular on co-operation with the International Criminal Tribunal for former Yugoslavia (ICTY), prosecution of alleged war criminals and regional co-operation, face harsh criticism from some radical nationalist groups. Despite occasional spectacular protests (e.g. road blockades by war veteran associations and mass demonstrations), such right-wing extremism has remained confined to marginal groups and has not presented a serious threat of destabilisation.

Public opinion seems much less interested than previously in nationalistic considerations and propaganda.

Local elections in May 2001 were held in a transparent and democratic environment and their organisation respected international standards. The elections showed a clear loss of interest, if not disillusion, by the public, as the low turnout (45%) showed. This is particularly problematic given the need for strong public backing of the reform plan if Croatia's transition is to be successful. The growing public discontent, which has resulted in an increasing loss of popularity by the Government, seems mainly due to the difficult economic situation, to the social impact of ongoing unpopular reforms and to the slowness in solving problems inherited from the previous Government. The Government plans another reform of the electoral legislation (the last reform having been at the end of 1999) and a new draft law is expected to be presented to Parliament in Spring 2002. The main objectives are to abolish the vote of the Croatian "diaspora" and find a more equitable system of proportional representation, including for minorities. There seems to be general consensus on the need to abolish the specific vote of the "diaspora", although there is support for a mechanism to allow Croatian citizens living abroad to be represented. The number of seats to be reserved for national minorities remains controversial.

Executive. Croatia has been governed by a five-party centre-left coalition since the Istrian Democratic Congress (IDS) left the Government in June 2001. The ruling coalition has a comfortable majority, with 88 out of 151 seats, although it does not have the 2/3 majority required for some of the outstanding legislative reforms. However, the heterogeneous profile and different interests of the various parties forming the ruling coalition lead to long internal negotiations on various issues, which has contributed to the slowing down of the reform agenda. In addition, the coalition has continued to experience some difficulties of internal cohesion, with differences between the main partners on major political issues occasionally leading to serious tension. The decision of July 2001 to confirm full co-operation with ICTY and hand over indicted Generals led to open conflicts and resulted in a Government crisis. The Government eventually emerged strengthened after surviving a vote of confidence by an overwhelming majority, and since then has appeared to be strong enough to keep the coalition together. The leaders of the different parties have publicly reaffirmed their loyalty to the present coalition, refusing to consider, for the time being, other possible options which would result in early elections. Although internal party affairs of the different coalition members could still affect government stability in the near future, the overall political situation should remain stable in the medium term. The recent government reshuffle should not lead to any major policy changes, neither to any particular instability.

The Government has started a process of decentralisation which will permit a fundamental reorganisation of the overall political system, strengthening **local government**. New legislation on local government, on the whole compliant with the different Council of Europe standards, entered into force on 1 July 2001. It provides for some devolution of powers to local self-government units, notably granting them greater powers in education, health and welfare. Another positive step was the nomination of heads of the new administrative offices at the county level, which removed state administrative responsibility from county prefects avoiding possible conflicts of interests experienced in the past. However, the activities of local authorities are still hampered by scarce financial resources and the fact that local authorities depend on central authorities for their finances, through an equalisation fund.

Civil society. Civil society has since 2000 operated in a generally tolerant environment but its role, in social and political terms, has been limited. The official number of civil society organisations in Croatia is high (around 16,000). However, the majority of these are devoted to sports and culture and the number of NGOs active in the social sphere and having national coverage and impact does not exceed 300. These active NGOs exist on relatively low membership levels, and as a body have diverse objectives, both of which facts hamper their leverage and impact. The existing absence of NGOs from policy making and legislative processes as well as the lack of a tradition of co-operation between NGOs and the private sector, further weakens their viability.

In the current political circumstances, with comprehensive reforms underway, the country would benefit from increased co-operation between the different institutional players and representatives of civil society. NGOs could be a crucial means of raising awareness and encouraging a more pro-active attitude in the public.

2.1.2. Assessment of the judiciary, law enforcement and respect for rule of law

Judiciary. The judiciary remains one of the most problematic areas, while its importance in underpinning a stable democracy is central. A radical, and urgent, reform is therefore needed.

The independence of the judiciary has been strengthened, but there are still cases of political influence at local level. The machinery of justice continues to be rather unstable and disordered. The major problems are: a) a large inherited backlog of pending cases (some 1.200.000, mainly simple cases); b) a lack of suitably qualified staff (judges, prosecutors and other court personnel) and appropriate professional training; c) inefficiency of the existing administrative organisation, with a need to redefine the competence of the supreme court and rationalise court organisation; d) an inefficient allocation of the budgetary resources. Although there seems to be awareness and common understanding within the Croatian judiciary and administration about the main problems and challenges of reform, the bulk of the work remains to be done. The various reorganisations of the Ministry of Justice have not helped. Progress so far consists in initial measures, taken recently, to address the problem of backlog (setting criteria for prioritisation, increasing staff numbers, simplification of procedures, decriminalisation). The Government has also initiated a reform of the legislative framework.

Police. The police service in general performs professionally, and disciplinary proceedings are instituted against officers whose performance is unsatisfactory. According to OSCE police monitors in the field, the service responds quickly to incidents of civil disorder and major crime. However, in some war torn areas there have been cases where police officers appeared to be reluctant to investigate ethnically motivated incidents fully. Police reform is underway and the Ministry of Interior has shown willingness to work closely with international partners on management and reorganisation in order to separate police operations from political influence. Further efforts are needed to ensure the proportional representation of Serbs in the police in Eastern Slavonia, as agreed in the Erdut agreement.

General Respect for the Rule of Law. In terms of general respect for the rule of law, adequate law enforcement remains one of the major problems. There is a worrying tendency to fail to implement not only politically sensitive court decisions but also more generally. The challenge is to develop an efficient mechanism to ensure implementation of decisions.

Positive developments can be noted in the area of war crimes, with the decision of the Croatian authorities to pursue a more determined policy of impartial prosecution, regardless of ethnicity. In August and September 2001 a number of proceedings were begun at domestic courts against ethnic Croats accused of war crimes in 1991 and during and after operation Storm. (*see also the para on co-operation with ICTY*).

Significant efforts have also been made to fight **corruption**, affecting to differing degrees all parts of the public administration. A specific action plan has recently been agreed. The plan aims to raise public awareness of the need to fight corruption, to increasingly involve civil society in the drafting of all legislation having an impact on corruption (conflict of interest issues, judiciary, public administration/local government reform, access to information, ethics in the private and public sector) and to train judges on codes of ethics.

2.2. Human Rights and Protection of Minorities

Croatia's human rights record has improved substantially. Human rights and fundamental freedoms aligned to international standards are constitutionally guaranteed and generally respected. Progress has been made in the completion of the supporting legislative framework.

The Government has taken steps which have improved the treatment of minorities. Some legislation to strengthen minorities rights has been adopted, but further efforts are needed to complete the legislative reform and ensure its full implementation.

The refugee return process still has some way to go, with a substantial effort still needed to solve outstanding problems. The reintegration of the Serb minority, in particular returnees, which is still subject to de facto discrimination, in particular at the local level, is a major problem.

2.2.1. Civil, political, economic and social rights

Croatia has ratified all the Council of Europe conventions to which it is committed by virtue of its membership. Croatia is also a signatory to nine of the twelve principal international human rights treaties of the United Nations.

Since 1996 Croatia has had an **Ombudsman** who regularly assesses the human rights situation in the country. However, the Ombudsman's annual report is not given enough political weight, and the Government should take more account of its findings and recommendations. It should also improve communications with the Ombudsman. The Ombudsman's office remains rather under-funded and under-staffed (14 staff dealing, for example, with 1200 cases in 2001). Most of the cases the Ombudsman is called to intervene in are linked to property restitution in the refugee return process. Pensions problems linked to the convalidation of citizenship are one of the other main issues.

New legislation on **freedom of association** entered into force on 1 January 2002. It removes many of the bureaucratic obstacles to the establishment of NGOs. It also gives a broader list of purposes for which an NGO may be formed, notably accepting "protection of human rights and freedoms". The legislation also includes tax incentives for charitable contributions to NGOs.

After a number of specific reforms which substantially enhanced the **freedom of the media**, progress is now stalling. The Law on Croatian Radio and Television (HRT) was finally adopted in February 2001. The Law on Telecommunication was modified in July

2001, contrary to the Government's earlier intention to adopt completely new legislation. The amendments do not appear to follow all the recommendations which the Council of Europe had made and the resulting legislative framework does not yet ensure the transformation of the state-administered broadcaster into a fully independent public service broadcaster. The existing laws do not remove the various legal, political and economic obstacles which currently hinder the development of other private broadcasters, and still allow for some political control of HRT's governing bodies. The recent personnel changes do not replace the need for a reform of the organisational structure of HRT. Finally, the government has not yet taken steps to privatise the third channel as provided for in the legislation.

Journalists work in an open and pluralistic environment and media coverage is in general balanced. The media is starting to play an important role in opening discussions on sensitive issues in Croatia's recent past, for instance with the transmission of a documentary of the military action during Operation Storm which was also broadcast in FRY. Articles or broadcasts of this kind raise public awareness of these issues and can contribute to the identification of responsibilities, which is a positive step. However, the lack of qualified journalists and proper training has a direct impact on the overall quality of the media and political interference at the local level is still possible and occurs occasionally, normally on particularly sensitive political issues.

Equality before the law and non discrimination are protected as constitutional principles. Nevertheless, in practice, discrimination and racism are not always discouraged strongly enough by the authorities and are not properly sanctioned. As an example, although racist propaganda is forbidden by the constitution, it has not been explicitly prohibited by law and therefore is not punishable. The number of cases of hate speech against Serbs, which are most prevalent at a local level, is diminishing but has not completely disappeared. The present leadership is becoming much more reactive to these kind of situations, publicly criticising reported cases.

Trade unions in Croatia are generally independent. There are five major labour confederations and several large unaffiliated unions. Approximately 64 % of workers are union members. There could be better co-operation between the unions and the Government, through the establishment of stronger consultation mechanisms, notably in the ongoing reform of the public sector and the collective agreement negotiations.

2.2.2. *Minority rights and refugees*

The adoption of a new Constitutional Law on Minorities, containing guarantees for all individual and collective rights and following all the recommendations made by the Venice Commission, has again been postponed, now until summer 2002. In the meantime, the transitional regime (based on amendments to the existing legislation) which was supposedly introduced for only six months in May 2000 and which addressed only the most urgent problems of discrimination against minorities is still in force.

Official use of minority languages, the right to education in minority languages and participation of minorities in local self government bodies, are covered by ad hoc legislation. According to OSCE and Council of Europe experts, these laws are in line with international human rights standards. The Law on local elections of April 2001, guarantees proportional representation for minorities according to their number. However, the way in which this will be achieved can only be decided on the basis of reliable data on the ethnic composition of the population. This was collected in the 2001 census, and should be made available at latest within one year after their collection (i.e. April 2002). Further delays in the publication of the census data would hardly be

explicable by technical problems alone. Implementation of the legislative framework should be improved.

The treatment of the Roma population raises concern. Although the Government has for the first time recognised their status as a minority group, Roma still suffer discrimination in social and economic relationships. There has also been an increasing incidence of racially motivated violence against the Roma population during 2001, to which the authorities did not in all cases react critically enough. The Government therefore needs to develop a policy to ensure fair treatment and protection of the Roma.

The Government maintains its stated commitment to implementing all obligations related to the **return of refugees and displaced persons** contained in the Dayton agreement. However, in practice there are still obstacles to return of refugees from abroad¹.

In terms of the legal right to return, those who have citizenship can return freely. Those without citizenship continue, however, to be subject to long administrative procedures, needing approval from the Ministry of Interior and the Office for Displaced Persons and Refugees. Problems exist in particular for those for whom there are no traces concerning residence in 1991; according to UNHCR between 700 and 800 people are currently in this situation.

An important question inhibiting return is availability of housing. The ongoing problems are property restitution, the resolution of lost occupancy/tenancy rights and the delay in reconstructing houses destroyed in the 1995 operations. The difficulty of those refugees who left their homes in regaining the right to live in them has been a crucial deterrent to return. This is the case both where the returnees were the owners of the property and where they had occupancy/tenancy rights to the property. In the first case, the problem is that properties were allocated under the Law on Temporary Take-over to new owners, mostly Croat refugees from BiH. The lack of alternative accommodation for those given temporary rights means that owners cannot move back. In addition, the authorities fail to enforce in a systematic way eviction orders issued following a decision on property rights, which is coupled with a clear lack of co-operation by some local officials,

building sites plus building materials. This was a welcome attempt to address the issue of restitution of rights in a pragmatic way for those willing to return. No concrete follow-up, however, has been given so far.

The final housing issue is reconstruction. The Government, in co-operation with UNHCR, undertook a campaign in Serbia and BiH to publicise the 31st December 2001 deadline for requests for reconstruction to be made. Even before the new applications received as a result of this, County Offices for Reconstruction had been slow in issuing decisions for reconstruction.

The lack of economic opportunities is a further important factor discouraging return. As a consequence to a large extent only elderly people are returning, notably in some of the return areas which were already experiencing economic difficulties (such as the Knin region) further aggravated by the aftermath of the war. The Government recognises this problem and is attempting to address through its support for Areas of Special State Concern.

The judiciary has taken a number of useful steps to improve the application of the Amnesty Law and stop unjustified arrests on suspicion of war crimes. Fears of arrest are, however, still influencing, and deterring, those considering returning. Security incidents related to Serb returnees are very sporadic and limited to a few regions but still occur. The security situation in Eastern Slavonia has substantially improved and efforts continue to encourage reconciliation and pursue normalisation of life.

2.3. Regional Co-operation

Croatia has a key role to play in the long-term reconciliation and stabilisation of the region. The Croatian authorities accept this role and the corresponding need to normalise relations and strengthen bilateral co-operation with neighbouring countries, a key element in this process. Concrete implementation of positive statements still requires further effort, however. While steady progress has been made in the bilateral relationship with BiH, the pace of change in the relation with FRY, which is fundamental to the stability of the region, has remained slow. There have, however, been recent encouraging signs of an improvement in this latter relationship. In terms of regional commitments, Croatia continues to fear that closer relations with its SAP neighbours will lead to the re-emergence of a regional identity and hold back its ambitions for EU integration. As a consequence, the authorities show a clear lack of enthusiasm for any regional initiatives with the other SAP countries.

The government's formal attitude towards regional co-operation has been much more constructive than the previous regime, but such co-operation is still an emotional subject in Croatia, both in politics and in public opinion. Regional co-operation is a recurrent subject of discussion within the coalition and the opposition, and any possible development of it are given prominence in the press. Croatia continues to show fears that its destiny and its European future might be linked to developments in the rest of the region, regardless of its own achievements. This is translated into continuing criticism of the EU policy of regional co-operation and a consequent resistance to all regional initiatives which are perceived as strengthening the regional identity at the expense of closer integration with candidate countries and the EU. A recent example has been the criticism by the opposition of the SAA provisions on regional co-operation on the basis that they are designed to lead to a Balkan association. This interpretation is a clear, and apparently intentional, misunderstanding of the content and implications of the provisions, which have been clarified many times by negotiators. This general attitude

(latest polls showed that 70% of the participants considered the obligations on enhanced regional co-operation as a negative consequence of the SAA) is difficult to understand and justify since EU policy is clear on this point: regional co-operation among the SAP countries is the main instrument to ensure stabilisation in the region, and is therefore a fundamental condition of a rapprochement to Europe, but each of the countries will be judged on its own merits and progress and will not be obliged to follow a "regional destiny".

2.3.1. *Multilateral co-operation*

The government is fully committed to compliance with the obligations under the **Dayton/Paris agreements**. (Developments in the return process are considered above, see chapter 2.2.2).

The authorities are proving their determination to co-operate with the **International**

renounced the "special parallel relationship" with the Federation of BiH (FBiH), establishing political co-operation exclusively with Sarajevo.

Croatia also played a positive role when the Bosnian Croats proclaimed "self-rule", urging them to look for a solution within the existing system (although some opposition voices still advocate constitutional change within BiH). Financing of the Croatian military component in the FBiH has also stopped and the Government is working to monitor and prevent any misuse of the present financial assistance to the FBiH. Croatia and BiH have started negotiations on an agreement on dual citizenship aimed at abolishing BiH Croats' right to vote in both Croatian and BiH Parliamentary elections. A Free Trade Agreement providing for a gradual implementation of a free trade area, has been applied since 1 January 2001. With the agreement Croatia agreed to dismantle custom duties and quantitative restrictions as of the entry into force while BiH has been granted a three year transitional period. Liberalisation of trade in services and provisions on investment are mentioned as areas for future possible agreements.

Nevertheless, some unresolved issues remain. Tensions arose recently over the Croatian decision to ban the road transport of oil products through its territory on environmental grounds. Relations with Republika Srpska remain highly emotional and contacts between the populations remain limited. An agreement on return, to facilitate and accelerate the return of refugees, was signed between BiH and Croatia in December 2001. The Agreement on State borders, signed in 1999 and provisionally applied, has not yet been ratified by either country and some issues linked to the definition and respect of borders still occasionally arise.

Relations with the **Federal Republic of Yugoslavia** have started to improve after the fall of Milošević and his extradition to The Hague but the pace of improvement has been slow. Economic ties are humming back to life and could encourage better political co-operation. Recent important steps have been made with meetings of the Ministers of Foreign Affairs which resulted in operational conclusions which have started to pave the way for a better understanding and a normalisation of relations. As a first result, the countries have established relations on ambassadorial level and have set up an inter-state commission on borders to settle outstanding border issues (Prevlaka and Danube frontier line). The recent return of cultural artefacts to Croatia has contributed to a more positive atmosphere and discussions on a cultural co-operation agreement have started. Some bilateral agreements were signed in December 2001 (abolition of double-taxation, co-operation between the Ministries of Foreign Affairs) and negotiations have started on a Free Trade Agreement. However, of particular importance is the need to speed up the process of return of refugees and DPs, to resolve the fate of missing persons, to pursue a policy of war crime prosecution not based on collective accusation but only on individual responsibility based on evidence and to properly regulate the status of minorities. These are very sensitive issues, often provoking emotional reactions on both sides, and normalisation of the Croatian-Yugoslav relationship will largely depend on progress made in spite of these emotions. Croatia continues to operate a more restrictive visa regime with the FRY than towards other countries of the region.

Relations with the **former Yugoslav Republic of Macedonia**, the only other country to have signed a Stabilisation and Association Agreement (SAA) with the EC, continue to be good. Negotiations for a bilateral convention on regional co-operation under Art. 12 of the SAA are well advanced. A Free Trade Agreement between the two countries is already in force.

Relations with **Slovenia** remain good overall despite the outstanding bilateral issues of land and sea border definition and the debt of Ljubljanska Banka. A positive step was

made with the signature of an agreement on the Krško Nuclear Power Plant, which had burdened Croatian-Slovenian relation over the past ten years. Once applied, both parties will own, run and use the plant on an equal basis.

On the questions which remain, an agreement defining the land and maritime borders was initialled in July 2001. The agreement is seen by negotiators on both sides as a reasonable compromise, but it met with clear disapproval from the opposition and provoked disagreement within the ruling coalition when it was presented to Parliament. In the absence of a 2/3 majority in its favour, it has still not been ratified by the Croatian Parliament. A recognition that the border issue and the disagreement over the debts of Ljubljanska Banka must be solved, and that this will involve compromises on both sides, would demonstrate an increased level of political maturity.

Croatia has maintained good bilateral relations with the other **countries of Central and Eastern Europe**. The Government has sought a reinforcement of commercial ties with all these countries and rapid progress has been made in the conclusion of Free Trade Agreements (*see chapter on trade*). Croatia has a strong desire to accede to CEFTA and expects to be accepted as a member by mid 2002.

As far as bilateral relations with neighbouring **EU Member States** are concerned, the basically good relations with **Italy** are hampered by some on-going, long-standing issues, which remain difficult to resolve. The main problems are the properties of Italian refugees who left Croatia after the second World War, the treatment of Italian minorities in Croatia and the lack of co-operation to prevent incidents in the Adriatic sea. However, Croatia is participating in several sub-regional initiatives launched by Italy and an agreement on cultural co-operation between the two countries has recently been negotiated.

2.4. Priority Areas Needing Attention in the Next 12 Months

- Adopting new electoral legislation to re-define the representation of the "diaspora" and ensure proportional and appropriate representation of minorities. Timely publication of the final results of the 2001 census to allow full implementation of the provisions of the new legislation on proportional representation of minorities in local elections.
- Establishing a strategy for a comprehensive reform of the judiciary. Completing the legislative framework on judiciary. Putting in place and implementing measures to reduce the backlog of cases. Beginning a reorganisation of the court system. Establishing programmes for the training of judges and prosecutors. Taking measures to ensure proper and full execution of court rulings.
- Ensuring full respect of human rights, in particular minority rights. Every effort should be made to adopt without delay the Constitutional Law on the protection of minorities. Steps should be taken to eliminate the *de facto* discrimination of some minority groups, notably Serbs. Establishing a strategy for the protection and integration of Roma.
- Modifying the legislative framework for Croatian Radio Television (HRT) in order to begin the process of its transformation into a fully independent public service.
- Strengthening regional co-operation, in particular by improving bilateral relations with FRY. Finalising negotiations for Free Trade Agreements with Albania and FRY and concluding negotiations on the bilateral regional convention with former Yugoslav Republic of Macedonia. Working to find definitive solutions to the pending

border issues, in particular Prevlaka and ratification of the border agreement with Slovenia.

- Strengthening co-operation with ICTY to comply fully with the existing obligations.
- Speeding up the return of properties, finding an appropriate solution for occupancy/tenancy rights and removing all administrative and legal obstacles to return. Assessing the potential for economic development in return areas to increase the sustainability of return.

3. ECONOMIC SITUATION

The Croatian economy continued to grow in 2001, driven by domestic demand and a successful tourist industry. The authorities adopted a number of difficult decisions with the aim of achieving fiscal sustainability and modernising the economy. However, political obstacles slowed down progress and postponed the implementation of some structural reforms into 2002.

3.1. Current Economic Situation

Macroeconomic data for 2001 indicate a generally positive trend for the Croatian economy.

Real GDP continued to grow in 2001 by an estimated 4.5% in 2001, as expected (compared to 3.7% in 2000). Domestic demand, i.e. private consumption and investment, has been the driving force for this growth, since there has been a significant reduction of government consumption, thus reflecting growing consumer and business confidence. While the tourism sector fulfilled expectations in 2001, administrative services continued to shrink, reflecting the declining government consumption.

Inflation slowed down markedly in the course of the year in spite of an acceleration in the first months as a result of higher oil prices and one-off increases in excise taxes. The inflation rate fell to 2.6% in December 2001 (year-on-year, 2000: 7.4%) for retail prices (the average 2001 retail price inflation was of 4.9%).

The level and the trend of **unemployment** remains worrying. Despite sustained economic growth and significant investment, the already high unemployment rate continued to increase according to the usual seasonal pattern, and reached 23.1% in November 2001. The official rate is however likely to overestimate the actual employment situation: studies suggest that about 100,000 people, i.e. more than a quarter of total unemployed, are active despite being registered as unemployed. The government has therefore taken action to better target unemployment benefits through a new Employment Act passed in November 2001.

Fiscal performance in 2001 seems to have improved but it increasingly relied on discretionary measures such as fiscal savings in subsidies and transfers, goods and non-wage services and capital spending. Following two budget revisions, the central government **budget deficit** is expected to meet the limit agreed with IMF of 5.3% of GDP on an accrual basis (compared to 5.7% of GDP in 2000). A number of laws, notably the new wage policy law and a package of 11 laws to rationalise the social transfer system, were completed later than expected, thus reducing the budget savings in 2001. These reforms are expected to benefit future budgets. The intended net reduction of employment (10,000 staff) by December 2001 will probably only be completed by March

2002. Expenditure overruns were partly offset by a slower reduction of arrears than

companies had to a large extent been sold. The main operation in 2001 was the sale, for €500 m, of a 16% stake in Croatian Telecom (HT) to Deutsche Telecom (DT), thus making DT the majority shareholder with 51%. Some of the hotels on the Dalmatian coast were also successfully privatised. Out of HFP's portfolio, a number of non-profitable enterprises were sent into bankruptcy. Planned privatisation revenues of HRK 8.5 bn (€1.15bn), essentially earmarked to cover the budget deficit, had to be revised downwards to HRK 5.5. billion (€740m), of which almost 80% came from the sale of HT.

The Government announced its intention to sell a majority stake in other major companies. Dubrovačka Banka has recently been privatised and the tendering procedures have been launched for Croatia Banka, which has already been restructured). An advisor has been appointed to sell a majority stake in the Croatian insurance company Croatia Osiguranje to a foreign strategic investor. The privatisation of a 51% stake of the Adriatic pipeline operator JANAF is tentatively planned for 2002. The government is reviewing the options for the sell-off of the oil and gas group INA and plans an Initial Public Offering in the case of the electricity monopoly HEP. However, the privatisation of both INA and HEP has been put back until the end of 2002 following delays in the adoption of the regulatory framework and subsequent privatisation laws. The Government also postponed until 2002 the recapitalisation of the Croatian Postal Bank (HPB). It has announced its intention to privatise the shipyards once they have been restructured. The

significant and numerous bureaucratic hurdles. The overall situation is discouraging for foreign investors and inhibits growth by domestic investors.

The range of available financial products is slowly being modernised. However, long-term finance is still scarce, reflecting the problems in providing collateral for financing purposes. The financial sector in general remains underdeveloped, essentially restricted to banking products, and with only a limited number of listed companies. However, steps have been taken to unite the Croatian and Slovenian capital markets, and the introduction of the three-pillar pension system is expected to lead to an evolution of capital markets.

3.3. Management of Public Finances

The **tax base** of Croatia's budget has been expanded over the years. Since its introduction in 1998, VAT has been the single most important revenue source, accounting for more than 50% of total revenues. In 2001 tax revenues (excluding social security contributions) grew by 2.2% in the first ten months compared to the same period in 2000. A law was adopted in December on uncollected claims whereby the state will try to collect, by writing off and rescheduling, at least part of a 23.5 billion kuna (€3.16bn) debt which companies owed the state by the middle of last year.

However, the overall tax burden in Croatia borne by the private sector is one of the highest in the region and is likely to have both driven a substantial part of underground economic activity into that sphere and to have reduced profitability in the formal sector. With revenue raising capacities limited, most of the adjustment will have to be made on the expenditure side, including improvement of the effectiveness of budgetary management.

Progress was achieved in **budget management** with the application from 1 January 2001 of a single treasury account system, which has since June 2001 also covered all extra-budgetary funds except the health fund. The single treasury account system has certainly facilitated cash management and expenditure control, and thus increased transparency, but it does not provide a tool against over-commitment of funds. There are still some downside risks particularly in budget implementation. The public expenditure review of the World Bank established that the current budget is not comprehensive, that the budget formulation is dispersed, that the expenditure control lacks flexibility, and that budget execution is not co-ordinated and lacks monitoring and control of commitments. It also identified deficiencies in internal control and auditing. The budget for 2002 took onboard several recommendations, for instance the budget included for the first time the pension and health funds and the employment bureau. The Law on the Execution of the State Budget for 2002, adopted in parallel, provides for more flexibility to reallocate budgetary expenditure. However, the budget for 2002 also establishes two development funds to end the utilisation of capital revenues for current expenditure.

3.4. Priority Areas Needing Attention in the Next 12 Months

- Improving fiscal consolidation in 2002 to progress further towards sustainable public finances. This will require strict expenditure control and execution of the budget plan, so as to avoid the need for discretionary measures and to create room for government investment expenditure to pick up in future years.
- Implementing measures to reduce the public sector wage bill, as well as reforming and modernising pension and health systems and streamlining and harmonising data collection for the social system.

- Pursuing privatisation, notably to complete the announced projects (Croatia Banka, HPB, Croatia Osiguranje, HEP and INA) and make progress in divesting the shares held by the State Privatisation Fund.
- Adopting measures to create a business environment conducive to growth, including starting to reform cadastral records and land registry.

4. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS

4.1. General Evaluation

4.1.1. Status

Deepening relations with the EU remains one of the Government's key objectives, with a view to the gradual integration of Croatia into the European structures. The most notable single event during 2001 was the signature of the Stabilisation and Association Agreement on 29 October. The ratification procedures for the Agreement are now ongoing: the Croatian Parliament ratified the SAA on 5 December 2001 by a qualified majority; the European Parliament gave its assent on 12 December 2001. The ratification of the Agreement by all the national Parliaments of the EU Member States is required for its entry into force.

The SAA is the first comprehensive contractual relationship for Croatia with the European Community.

The SAA was generally welcomed in Croatia. The main opposition party, HDZ, criticised the SAA on the basis that it does not give Croatia a guarantee of future EU membership (which is not the purpose of the SAA).

Pending the entry into force of the SAA an Interim Agreement covering trade and trade-related matters has been applied provisionally as from 1 January 2002 and entered into force on 1 March 2002.

Trade in textile products is also governed by a separate agreement which has been applied from 1 January 2001.

In order to complete the contractual trade regime, a wine protocol to the Interim Agreement and to the SAA was signed on 7 December and has been applied as from 1 January 2002. The protocol establishes reciprocal concessions for exports of wine and defines the rules for the protection of denominations of wines and spirits.

At the signature of the SAA it was decided between the parties to establish a formal political dialogue between the EU and Croatia. The first official political dialogue meeting took place the following day.

4.1.2. General assessment of administrative capacity

The Ministry for European Integration (MEI) is charged within the administration with the implementation of the SAA and the co-ordination amongst other ministries. It has adopted an efficient, professional and open approach to these tasks and also to raising awareness both within the administration and with the general public of the impact of the SAA and the extent of the required reforms.

The reaction of involved Ministries and State Offices and Agencies to the SAA has varied. In general, though, both the negotiation process and the beginning of the

implementation phase seem to have stimulated the involvement of a wide range of Ministries. There is, however, a lack of capacity, in terms of staff numbers and more specifically in terms of a lack of proper expertise, in many sectors which are faced with making domestic reforms compatible with EU standards and with the gradual implementation of the EC *acquis*.

4.1.3. Impact of the SAA/Interim Agreement on reform

With the SAA Croatia has accepted wide-ranging obligations, the implementation of which will require substantial efforts, beginning with structural reforms in a number of sectors.

With the application of the Interim Agreement having begun only in January 2002, it is too soon to make any evaluation of its implementation. In October 2001 the Government adopted an action plan for the implementation of the SAA, defining for each ministry the measures to be taken and setting a clear time frame. The plan was the result of a co-ordinated effort by all ministries, agencies and other concerned administrative entities and will be monitored by the MEI.

The existence of the action plan is encouraging in that it shows the seriousness of the commitment by the Government, as well as general awareness and ownership. However, the timetable, which would require that 70% of the EC *acquis* be transposed within two years, appears highly ambitious and, in the light of experience elsewhere, potentially unrealistic.

4.2. Internal Market and Trade

Croatia has the capacity to implement the obligations accepted in the framework of the SAA/Interim Agreement. The implementation of the first tranche of trade concessions, from 1 January 2002, has not raised problems so far.

The Government is actively working on the development of legislative harmonisation strategies and has begun gradual implementation in the field of trade-related legislation. A long-term commitment to this demanding process is needed.

Croatia has started to establish the necessary inter-ministerial co-ordination mechanisms. The capacity of the Ministry for European Integration, the co-ordinator of the SAA/Interim Agreement implementation process, has been substantially reinforced. Efforts need to be made to create/strengthen administrative capacity in all line Ministries, Agencies and Offices that will be involved in the process of harmonisation with European legislation and practices, starting with areas where contractual obligations already exist.

4.2.1. Movement of Goods

Croatia has made substantial progress in the liberalisation of its trade regime. A radical reduction of trade barriers has taken place, following WTO accession in July 2000, the conclusion of several free trade agreements (FTA) with neighbouring countries, and finally the application of the Interim Agreement with the European Community.

In line with the obligations within the WTO framework, Croatia committed itself to a phased reduction, over the period to 2005, of import duties for industrial and agricultural products to a level close to that applied by several OECD countries. Croatia has abolished all export restrictions, as well as quantitative restrictions or measures having equivalent

effect. Croatia has made rapid progress towards the commitments it undertook with the signature of the Stability Pact Memorandum of Understanding. Following the Government's enthusiasm in concluding Free Trade Agreements with its major trading partners, more than 90% of Croatia's trade is currently covered by preferential trade agreements. Croatia is linked by FTAs to BiH, the Former Yugoslav Republic of Macedonia, Hungary, Slovenia, Bulgaria, Czech Republic, Poland, Slovakia and EFTA. A FTA was signed with Turkey in March 2002 and is waiting for conclusion. Negotiations are ongoing with Albania, FRY and Romania.

In EC/Croatia trade relations, Croatia has benefited from very advantageous autonomous trade preferences granted by the European Community to the SAP countries. This regime has been confirmed and given contractual status by the SAA and the Interim Agreement, with further improved concessions for fisheries products. The current position is, therefore, that Croatia has duty-free access, without any quantitative restrictions, for its exports to the Community of all industrial products, all processed agricultural products and agricultural products with the exception of baby beef and wine, which are subject to tariff quotas, and bovine meat, which is excluded from preferential treatment. Fisheries products are also granted important preferences. From its side, Croatia has agreed to dismantle gradually its trade barriers on imports from EU Member States and to create a free trade area over a six-year transitional period. Croatia began by liberalising some 77% of trade in industrial goods as from 1st January 2002. Full liberalisation for textiles and steel products will take place by 1st January 2006, and by 1st January 2007 for all other industrial products. 75% of trade in agricultural products will be liberalised by 1st January 2006; 41% by the elimination of customs duties and 34% by preferential treatment covering traditional trade. Processed agricultural and fisheries products will also be fully liberalised by the end of the transitional period.

The implementation of the Interim Agreement should have a significant impact on the Croatian economy, since Croatia's major trading partners are EU member states (in order of importance Italy, Germany and Austria). Trade with the EU represents 54% of Croatia's trade flow, both imports and exports³. Croatia's exports to the EU remain the highest in the region, which makes Croatia by far the most significant beneficiary of EC trade liberalisation. However, the amounts remain very low in comparison to trade flow from central European countries. The trade balance remains heavily negative for Croatia due to the substantial reduction in Croatia's overall export level following its loss of international competitiveness – due essentially to wage growth above productivity growth, delayed enterprise restructuring and insider privatisation. The trend now seems to be slowly improving however.

Industrial products represent the bulk of Croatian trade. The main exports are textiles, chemicals and shipbuilding. The main imports include machinery and electrical equipment.

Agricultural products continue to be uncompetitive on European markets, with a trade balance largely positive for the EU. The sector represents 10% of Croatia's total imports (of which 42% comes from EU member states), and 14% of total exports (of which 10%

³ In terms of trade value, EU exports to Croatia for the years 1998, 1999 and 2000 amounted to €4.4 bn, €4 bn, and €4.6 bn respectively. The figure for the first nine months of 2001 is €3.9 billion. In percentage terms this represents around 0.5% of total EU exports to the rest of the world. Over the same years, Croatian exports to the EU totalled €1.8 bn, €1.9 bn and €2.2 bn respectively. Exports for the first nine months of 2001 should amount to €1.85 bn. In percentage terms this is around 0.2% of total EU imports from the rest of the world.

goes to EU markets). Since this sector was previously subject to high protection it is claimed to be the most sensitive to trade liberalisation.

Under the SAA Croatia accepted the obligation to gradually adapt its legislation in the field of **standardisation, metrology and accreditation** to Community technical regulations and procedures. Given the importance of these for trade liberalisation, such harmonisation should begin as early as possible.

The current legislative framework for the establishment of technical standards and certification (mainly consisting of a 1996 Law on Standardisation) needs to be substantially modified to be consistent with EC standards. A working group composed of the State Bureau for Standardisation and Metrology (SBSM), the Ministry for European Integration and the Office for Legislation is currently elaborating a National Strategy on compliance of technical legislation, which it is expected to finalise soon. Work on the modification of the whole legislative framework has already started and a set of key acts is being prepared. The Government has decided to postpone preparation of a new Law on Metrology until new Community legislation in this area is adopted.

The SBSM is responsible for the preparation, the adoption and the application of Croatian standards, accreditation and certification of products and legal metrology. It is an affiliated member of CEN, CENELEC and ETSI. It has established a number of technical committees involving some 2000 experts to help it in its work.

Many of the old Yugoslav standards are still valid, since they have not been replaced or cancelled, but they are ignored in practical terms. So far, a total of 2300 European standards have been integrated into the Croatian system (representing 24% of existing CEN standards, 12% of existing CENELEC standards and a number of ETSI standards), most of them during 2000 and 2001. However, the application of standards is still not mandatory in Croatia. In terms of certification activities, there are 11 accredited laboratories in Croatia, with ten more laboratories in the process of obtaining a license.

Under the SAA Croatia has committed itself to harmonising its legislation in the field of **consumer protection** to that in force in the EC, and to promoting a policy of active consumer protection including legal protection for consumers.

The existing Croatian legislation is fragmented, with no framework legislation on consumer rights and the only references to such rights being indirect and in a number of different acts. As a result, consumer protection is weak. No major developments can be expected before a clear legal basis is adopted.

The Ministry of Economy, in close co-operation with the State Inspectorate and with the active involvement of two major Croatian consumers organisations, Croatian Association for Consumer Protection (CACP) and Potrošač, has been working towards a substantial revision and reorganisation of the legislative framework since July 1998. A draft Consumer Protection Act, which the Government says is aligned to Community legislation, is under Parliamentary procedure with a deadline of June 2002 set for its adoption.

A draft Food Act, which was expected to be adopted by March 2002, is also under preparation.

4.2.2. *Movement of persons, services and right of establishment*

The SAA includes detailed obligations relating to the right of establishment and the supply of services, in order to create a free trade area which also includes services. These

obligations, excluding free road transit traffic, will only be applicable upon entry into force of the SAA, not being part of the Interim Agreement.

Croatia represents up to 70% of the region's exports of services. With an average increase of 10.7% on exports and 9.7% on imports, the service sector has been opening fast and performed well. Croatia has already started services liberalisation within the context of its WTO membership. Further efforts still need to be made to complete the privatisation process and build up the relevant institutional capacity. In the financial sector, privatisation of major state-owned banking and insurance companies is advancing.

Access by foreign companies has been liberalised by according foreign investors are accorded the same treatment as national investors in the exercise of their business activities. Under the Company Law there are no regulatory differences between domestic and foreign investors in the exercise of their business activities. However, a number of practical problems linked to the proper implementation of the legislation still exist, notably the heavy administrative procedures. In addition, legal uncertainty over property rights and ownership of assets contributes to the difficulty of access by foreign companies to the Croatian market. Work has continued on the establishment of a comprehensive legislative framework for the facilitation and protection of investments.

Approximation to the EC *acquis* in this area has already started and a number of the necessary institutions have been set up and are operational. Legislation on Company Law and Accountancy are being harmonised with the relevant EC Directives and the International Accountancy Standards, but substantial progress still needs to be made. For example, in certain areas such as data protection, no comprehensive legislative framework yet exists, although it may, as in that case, be under preparation.

4.2.3. *Movement of capital*

The SAA contains obligations in terms of liberalisation of capital movements which are not included in the Interim Agreement.

Croatia has liberalised current payments according to Article VIII of the IMF Agreement and will not have problems in implementing the Interim Agreement obligations in terms of free current payments.

As regards inward movements, Croatia has abolished exchange controls on direct investments (including the repatriation of profits and capital invested) and, with some exceptions, portfolio investments. However, it still maintains restrictions on the acquisition of real estate by foreigners, including foreign companies. The SAA sets out that within a transitional period of four years from the entry into force of the agreement the existing legislation should be modified to completely liberalise property rights. In addition to property rights, there are also restrictions on the establishment of companies and on the operations of companies already established in Croatia. This relates, concretely, to such things as obtaining permits to acquire real estate necessary for business and engaging key personnel from abroad.

4.2.4. *Customs*

The Customs Service in Croatia appears to be relatively well-developed given its relative youth (having been established only in the early 1990s). It is under the responsibility of the Minister of Finance and comprises a headquarters, 10 customs houses and 158 local offices. A reorganisation of the service to increase professionalism and efficiency is currently under discussion. Basic customs legislation is in force, with a new customs code consistent with the EC *acquis* having been adopted in 2000 and a modification of

the legislative framework for the implementation of the obligations of the Interim Agreement having been adopted in December 2001. However, serious problems remain in the enforcement capacity of the Service, creating difficulties in the collection of customs duties and in clearance procedures. The lack of specialised training of customs officers is one of the reasons for lack of enforcement. A co-ordination centre to address other weaknesses has been established but it does not include investigation, intelligence and anti-smuggling units. IT development within the Customs Service is proceeding but further effort is needed to put in place an appropriate, modern system. The customs infrastructure at border crossing points has been improved but still requires further investment.

4.2.5. Competition and state aid

The SAA, in article 70, provides for the application, in the trade relations between Croatia and the EC, of a competition and state aid regime based on Community legislation, and aligned with the Community *acquis*. This provision is included in the Interim Agreement and therefore has already entered into force.

Competition in Croatia is currently regulated by a legislative framework (adopted in June 1995 and amended in 1997 and 1998) which was inspired by European legislation. An independent authority, the Agency for the Protection of Market Competition, was created in 1995, and is directly responsible to Parliament. It has responsibility for enforcement of the existing legislation. Further harmonisation is required and the Agency is well advanced in drafting a new Competition Act, expected to be presented soon to the Government, to achieve this. Work is also ongoing on the drafting of a merger regulation (expected by March 2002).

The enforcement of competition policy is, however, much more problematic than establishing the necessary legislative framework, and serious efforts are needed in this

Agreement. For Community companies not established in Croatia a transitional period of three years from the entry into force of the Agreement is provided.

The existing legislative framework for public procurement dates from 1998 and is only partially consistent with EC legislation. Harmonisation with the *acquis* has started, with a new Public Procurement Act entering into force on 1 January 2002. According to this Act, public procurement functions have been decentralised, and a State Office for Public Procurement will replace the existing department for procurement and informatisation in the Ministry of Finance as the competent authority for the supervision and monitoring of procurement procedures. The major change resulting from the new legislation is that, as a general rule, goods and services exceeding a value of €28,000 (half the amount previously applicable) will be subject to public tenders. Special procedures are permitted in poorly specified "exceptional circumstances". Specific rules for transparency and publicity are provided, including an obligation to publish tenders exceeding €200,000 in the Croatian official publications as well as in the Official Journal of the European Community. The legislation applies to all public administration entities, including central and local government, entities owned by the state, legal entities using public resources or those financed from extra-budgetary funds such as the pension, health insurance and employment funds. The legislation allows national preferences only in exceptional, specified cases. It also establishes a detailed procedure to oppose decisions on tenders.

There is a need to strengthen the administrative capacity in this sector, by adequate staffing of the competent authority and training of that staff, and an increased transparency in procedures.

4.2.7. *Intellectual, industrial and commercial property rights*

The SAA, in article 71, obliges Croatia within a transitional period of three years to take the necessary measures to guarantee a level of protection of intellectual, industrial and commercial property rights similar to that existing in the Community. This provision is included in the Interim Agreement and therefore has already entered into force.

Legislation in this sector is reasonably well developed in Croatia, following the adoption, after Croatia's accession to the WTO, of a set of legislative measures which are said to be in compliance with WTO/TRIPS provisions and to differing degrees with the corresponding Community legislation. Croatia has also been a member of the World Intellectual Property Organisation (WIPO) since October 1991 and is a party to all the major international conventions in this fields (including all the conventions listed in the SAA).

A State Intellectual Property Office (SIPO) was founded in 1991. Its capacity was substantially increased at the end of 1996 when its competence was extended to cover industrial and commercial property as well as intellectual property. However a further increase in qualified staff from the current 95 and improved technical infrastructure is still necessary.

The SIPO has begun to establish an inventory of existing legislation and delivered some preliminary first results in November 2001. According to the Government's Action Plan for the implementation of the SAA, the review will be completed at the latest by December 2002. Croatia is in the process of defining its strategy to guarantee a similar level of protection as in the Community legislation, including with regard to law enforcement. Further amendments to the copyright law are expected in 2003.

Croatia is not yet a party to the European Patent Convention, although discussions are ongoing on a Co-operation and Extension Agreement which would be an interim solution

while awaiting accession to the Convention. In advance of the accession, the European Patent Office (EPO) plans to start active co-operation with the Croatian office, through offering training to its staff and conducting an evaluation of its needs to increase its administrative capacity and efficiency.

As regards law enforcement, there are four trade courts dealing with IP cases. Appeals against their decisions are examined by the High Trade Court in Zagreb. A number of remedies may be ordered by the judicial authorities, such as injunctions, damages, destruction or alteration of infringing goods and materials, publication of the judgement, moral and punitive damages. Criminal procedures are also available under certain conditions. Finally, provisional and border measures are provided by the law. It remains crucial that Croatia ensures effective application of these regulations and thereby provides for effective action against piracy and counterfeiting.

4.3. Sectoral Policies

4.3.1. *Industry and SMEs*

The Government has adopted a long-term development programme for SMEs to encourage the activities of small businesses, given their importance for economic restructuring and job creation. The small business sector contributes some 45% of GDP and is slowly starting to show some signs of dynamism, in particular by comparison with the increasingly difficult situation of the big industry. But the sector still faces significant hurdles, in particular its limited international competitiveness and concentration of production on domestic supply.

There are still a number of "internal" obstacles which constrain enterprises' operations and their further development, notably difficulties with financial institutions, the absence of adequate institutional support, and the lack of managerial skills. In addition, slow legal enforcement procedures, fragmented administrative responsibilities and land registration problems are general impediments to private sector development. There is therefore a need to develop and implement a comprehensive private sector development policy.

4.3.2. *Agriculture*

Agriculture still occupies an important place in economy and society. Family farms prevail, with a high level of fragmentation of the land and with 70% of farm households owning less than 3 ha. Formerly socially-owned "agrokombinats" are at various stages of restructuring, privatisation or restitution. The transition to a market economy and extensive war damage have both impacted strongly on the performance of the sector. The pace of reform has been slow and substantial structural reforms are still needed to cope with competitive pressure. As a step towards this, a legislative framework has been adopted which accelerates the distribution of agricultural land, modifies the tax system, encourages state investments in the sector and favours the development of agricultural tourism and health food industry. The Government has so far failed to adopt the regulations needed to implement the reforms foreseen. The Government has, however, started working on a modification of the incentives schemes to encourage structural reforms in the sector.

4.3.3. *Environment*

Croatia has many environmental problems and existing environmental institutions remain under-resourced to deal with them. Many ecologically fragile areas of high biodiversity value are being degraded due to unsuitable development or encroachment into protected

areas. The public is not sensitised to existing or potential environmental problems and civil society has so far had a minimal impact in field of environmental protection. However, positive steps have been taken with the adoption in December 2001 of a National Environment Action Plan (NEAP). The 2002 budget foresees a 10% reduction

resources, improve safety of energy supply, develop a better price policy and ensure environmental protection. It is too early to assess the impact of this strategy.

Telecommunications. Looking at electronic communications infrastructures, the fixed-line telephone network in Croatia has been almost fully digitalised and telepenetration has reached 34 lines per 100 inhabitants, which is high compared to other countries of the region. The penetration of mobile services has more than tripled over the year 2000 to 23 mobiles per 100 inhabitants.

Important steps towards compatibility with the EC *acquis* were taken in July 2001 with the modification of the Telecommunications Law. The new legislation created a two-level entity in the National Regulatory Authority. The first level is the Institute for Telecommunications, an expert body responsible for all preparatory activity. The second level is the Council for Telecommunications, whose seven members were appointed in December. Full liberalisation of the sector is planned for 1 January 2003, which requires appropriate capacity in the regulatory authority.

4.4. Cooperation in Justice and Home Affairs

Croatia is committed under the SAA to fostering co-operation in justice and home affairs domestically and internationally.

However, severe shortcomings exist, both in the legislative framework and in the administrative capacity to deal with key areas, in particular asylum and the fight against organised crime. Illegal trafficking in and through Croatia is of increasing concern.

4.4.1. Visa, border control, asylum and migration

The Government did not meet its own December 2001 deadline to produce a comprehensive review of the legislative framework covering these areas.

The **visa** regime is regulated by law and the Government is trying to harmonise as far as possible its regime with Schengen. The list of countries whose citizens need a visa to enter Croatia is largely the same as the list established by the European Community.

Croatia still has pending **border demarcation issues** with some of its neighbours. The green and blue borders with Slovenia have not been agreed. The border agreement of 1999 with BiH, although already applied, has not yet been ratified, and recent minor disputes which have arisen recently suggest that this issue needs to be resolved formally. There are also some questions in the definition of the borders with FRY, in particular Prevlaka.

With regard to **border management**, in parallel with strengthened border control by Slovenia on the joint border in preparation for the introduction of Schengen standards, the Croatian border police have started a more strict surveillance of border areas with Bosnia and Herzegovina, particularly in the Bihac area. The number of motorised and helicopter patrol teams in forestry areas has doubled and customs officials are applying strict controls on regular border crossings. Despite these measures, there were 17,038 illegal border crossings in the first nine months of 2001, indicating only a slight improvement in comparison with the previous year. Romanians are still the largest group of illegal immigrants (44%), followed by FRY Albanians (14%) and then Turks (12%). Iraq, former Yugoslav Republic of Macedonia, Moldavia and BiH are other important

countries of provenance. In the light of these figures, it is clear that border administration needs strong reinforcement, both in terms of human expertise and technical equipment.

The **asylum and migration regime**, including voluntary repatriation to and from Croatia, deportation and family unification, is at present defined by a variety of legal instruments.

The current legislative framework for third country asylum seekers is inadequate. A Law on **Asylum** to improve the situation is expected to be presented to the Parliament early in 2002. The main shortcomings of the existing legal provisions are the absence of established procedures for assessing applications and of procedures at borders for dealing with asylum seekers. Clear guidance needs to be given to border authorities, in particular to guarantee transparency of procedures and to ensure that the principle of non-refoulement is respected. An interim asylum procedure, set up with the assistance of UNCHR in 1998, is at present used to assess applications but it does not cover local integration or the return of rejected asylum seekers and cannot therefore be seen as comprehensive. In addition the procedures it established are insufficient. Asylum seekers must currently file their application for asylum at the police precinct of Zagreb. The application is then registered by the Ministry of Interior (or the Office for Displaced Persons, Refugees and Returnees if the asylum seeker is from within the region), which examines applications on a case-by-case basis and issues decisions, after consultation with the Ministry for social affairs. Since 1997, when the first applications were submitted, no positive decisions have been given. Appeals against decisions can be filed with the Administrative Court but there have been very few cases so far. In practice, asylum seekers are treated as illegal aliens until an official request for asylum is made. They are accommodated either in a detention centre or in the UNHCR funded reception centre.

A new Department for Asylum and Aliens has been created in the Ministry of Interior, containing four divisions: Aliens' Status Issues, Asylum, Visa and responsibility for the Reception Center for Aliens. However, there is an overall lack of capacity in the asylum division in terms of equipment, human resources (three legal officers) and real expertise. Similarly, the police staff who receive and process asylum applications lack appropriate training. As a result, asylum procedures normally take up to six months which, considering the small number of applications and the superficial nature of the assessments, is too long. NGOs and lawyers are not yet skilled in providing legal assistance to refugees and asylum seekers. Such assistance would allow more challenges to be made and thereby help encourage change to the system.

As regards **migration**, a working group led by the Ministry of Interior has produced a first draft of a new Law on Foreigners. This draft needs to be revised to address better Croatia's migration specificities and trends as well as the latest developments in EU policy and legislation. Negative demographic trends and the need for increased foreign investment in Croatia should also be taken into account.

A joint declaration concerning closer regional and bilateral co-operation in the struggle against illegal migration and organised crime and for the harmonisation of prevention and implementation strategies was signed in Slovenia between the Ministers of the Interior of Croatia, Slovenia, Italy, Austria and Hungary. The five ministers defined, *inter alia*, a joint visa policy aligned with Schengen rules towards countries from which most illegal immigrants arrive. Other results of this declaration are that Croatian police will start joint patrols with colleagues on the other side of the borders and improve the exchange of data with these services.

Croatia has concluded re-admission agreements with eight Member States (in chronological order: Greece, France, Italy, Austria, Benelux and Sweden) and nine candidate countries (Hungary, Slovakia and Slovenia, Poland, the Czech Republic and the Baltics). Agreements have been signed with two SAP countries (former Yugoslav Republic of Macedonia and BiH, although the one with BiH requires revision). Negotiations are ongoing with three other EU MS (Spain, Denmark and Finland)⁴, two candidate countries (Bulgaria and Turkey) and the other two SAP countries. There is no information available on the number and status of re-admission agreements with countries with high migratory risks.

4.4.2. Money laundering

A largely satisfactory legislative framework to combat money laundering exists, shaped around the main international instruments which Croatia has ratified. The system does not allow the registration of an anonymous company or the opening of an anonymous bank account. A specific office for the prevention and combating of money laundering has existed within the Ministry of Finance since 1997. The office is trying to increase international co-operation and has already established links with some Member States and candidate countries. Croatia is also active within the relevant groups of the Council of Europe and as a member of the International Association of the Criminal Police (INTERPOL). In 1999 Council of Europe experts issued a positive evaluation of the efficiency of Croatia's measures to combat money laundering.

4.4.3. Fight against organised crime and terrorism

An important first step in the strategy to **fight corruption and organised crime** was the adoption in October 2001 of legislation reinforcing the institutional structures and establishing a new Office for the Fight Against Corruption and Organised Crime (USKOK)⁵, in compliance with the conclusions of the Stability Pact Anti-Corruption Initiative. The Office will act as a specialised body for public prosecution, to make investigation, prosecution and sanctioning of corruption and organised crime more efficient. It will also be responsible for developing and implementing a strategy of education and prevention. Although these first steps are encouraging, much work remains to be done to develop the capacity to implement fully the established strategy and to make the Office operational.

Croatia is already a party to the Council of Europe Convention on laundering, search, seizure and confiscation of the proceeds of crime and to the Criminal Law Convention on Corruption. Croatia has also signed the United Nations Convention against Transnational Organised Crime and the two Protocols.

Croatia has recently joined the Council of Europe's "Group of States against Corruption" (GRECO).

Croatia is committed to intensifying co-operation with its neighbours to combat organised crime, including in the framework of various regional initiatives, notably in the fight against terrorism. The USKOK has been given specific competence for organised crime. Croatia plans additional legislative measures to enhance the fight against

⁴ The only MS with whom Croatia has not yet started negotiations on re-admission agreements are Germany, Ireland, Portugal and UK.

⁵ The law providing for USKOK also introduces new instruments that should facilitate the state attorney's in obtaining evidence for prosecution, including instituting a "penitent witness" and the "right to block the property of a suspect".

organised crime, including ratification of the UN Convention against Transitional Organised Crime and the Protocols on Trafficking in Persons (women and children in particular), and on Smuggling of Migrants by Land, Sea and Air. The Protocol against Illicit Manufacturing of and Trafficking in Firearms, their Parts and Components and Ammunition is also expected to be signed and ratified.

On the specific question of the **fight against terrorism**, Croatia has signed six of the twelve UN Conventions against terrorism, and the Government recently decided to speed up procedures for ratification of/accession to the remaining six conventions. In addition, in November 2001 Croatia signed the European Convention on the Suppression of Terrorism. Procedures have also been started for the signature of the UN Convention for the Suppression of Financing of Terrorism. Croatia considers that a large part of the UN SC Resolution 1373 (2001) on combating terrorism can be implemented through its existing legal framework on criminal law, including provisions on combating corruption, organised crime and money laundering, but has committed itself to undertaking any additional legislative measures necessary to implement the UN SC Resolution. This includes law proposals that are currently in the legislative procedure such as the Law on Defence and the Law on intelligence services.

The role of Croatia in international **illegal trafficking** causes increasing concern. It is mainly a transit country but recently appears to have become an important destination country, in particular for the trafficking of women and children, mostly coming from the countries of the former Soviet Union and Bosnia and Herzegovina for the purpose of sexual exploitation. A new trend has recently been reported for the seasonal or temporary employment of trafficked women.

Croatia is also an important transit country on the Balkan route to Europe for the smuggling of **arms** and **drugs**. A comprehensive new law regulating the prevention and combating of drugs was adopted in December 2001. The law regulates and provides prerequisites for production of drugs for legal use. It establishes a co-ordinated policy for the treatment of addicts, including a supporting infrastructure. Finally, it creates a new anti-drugs inter-agency structure directly responding to the Government and in line with the requirements of the European Monitoring Centre for Drugs and Drug Addiction.

4.5. Priority areas Needing Attention in the Next 12 Months

- Implementing the trade liberalisation obligations undertaken with the Interim Agreement.
- Completing the implementation of the Memorandum of Understanding on trade under the Stability Pact by concluding Free Trade Agreements with all neighbouring countries by the end of 2002.
- Continuing gradual approximation to the Community legislation, in particular trade-related legislation and notably:
 - Adopting a new competition act and the necessary legislation regulating mergers. Increasing the administrative capacity of the Agency for the protection of Market competition including by a substantial increase in its staff. Adopting a legislative

- Completing the review of the legislative framework on intellectual, industrial and commercial property in order to establish a strategy for full harmonisation. Increasing the administrative capacity of the State Intellectual Property Office;
 - Improving the legal framework on Company Law and Accountancy;
 - Finalising the National Strategy on compliance of technical legislation and beginning to modify the legislative framework to adopt European standards;
 - Adopting adequate legislation on consumer protection, including the pending Food Act.
- Continuing alignment with the EU visa regime.
 - Adopting a legislative framework on asylum and migration in line with European standards. Basic standard reception conditions should be put in place. Start negotiations with Albania and FRY on readmission agreements and modify the existing readmission agreement with BiH.
 - Strengthening administrative capacity of the existing bodies operating in JHA related areas by adequate staffing and training.

5. FINANCIAL ASSISTANCE

Overall, **between 1991 and 2001** (included) Croatia has received €430 million of EC assistance. Until 2000 this was principally humanitarian aid or reconstruction assistance through OBNOVA. In 2001, €60 million was allocated under the CARDS programme:

- The largest financial allocation was made to refugee return (€23.2 million), continuing the orientation of previous assistance.
- For the first time, significant resources (€36.8 million) were also allocated to economic development and to assisting Croatia meet the commitments it has undertaken in the Stabilisation and Association Agreement.
- The specific areas covered were: human capital, industrial standards, energy infrastructure rehabilitation, justice and home affairs, integrated border management, public administration reform, intellectual property, competition policy, statistics, small scale operations and strategy development capacity building.

In addition, Croatia was allocated €0.5 million in 2001 for micro projects under the European Initiative for Democracy and Human Rights (EIDHR), as well as benefiting from region-wide projects under the same Initiative.

There have been no major delays in **implementation**, with funds for reconstruction under the refugee return programme from 2000 being disbursed during 2001, giving continuity of support. There has however been some delay in the start of a complementary SME support programme, due to discussions between the Commission and the Government over conditions of implementation.

In terms of the **capacity of the Government** to manage the increased amount of assistance it will receive, both from EC and other sources, an aid co-ordination structure has now been put in place. In October 2001 the Government appointed the Minister for European Integration as National Co-ordinator for EU Assistance and Co-operation Programmes. It also took other decisions setting up the necessary structures to manage the assistance, notably to establish project implementation units in all relevant ministries, and to establish a Central Financing and Contracting Unit in the Ministry of Finance. This framework should be sufficient for successful implementation of assistance

programmes, but has yet to be fully put in place or tested. Project implementation units need to be established according to the decision taken and the numbers and capacity of staff in relevant line ministries and agencies still needs to be increased.

In accordance with the CARDS regulation, a **Country Strategy Paper** for Croatia, defining the main areas for co-operation for the period 2002-2006, was adopted in December 2001. The associated **multi-annual indicative programme** sets out in more detail priorities for the period 2002-2004. These papers take fully into account the priorities of the Stabilisation and Association Process and in particular the Stabilisation and Association Agreement, and focus on democratic stabilisation (the return of refugees and displaced persons, civil society), economic and social development (trade, investment climate, social cohesion), justice and home affairs (modernisation of justice, policing and organised crime, integrated border management), administrative capacity building (public administration reform, national, regional and local development, public finance), and environment and natural resources. These programmes represent a significant broadening of Community support to Croatia, and therefore a shift in orientation by comparison with earlier Community assistance and a continuation of the approach taken in programming 2001.

A Commission-EU Member States co-ordination mechanism on assistance, initiated by the Commission Delegation, has been in place throughout 2001, to maximise the impact of CARDS and member states' aid. Monthly meetings take place to exchange information between the Commission and Member States on ongoing projects as well as on planned activities. The involvement and co-operation of Member States has been very high. Informal, but effective, co-operation exists with other donors, in particular USAID, and the International Financing Institutions, in particular the EBRD, the World Bank and the EIB

6. PERCEPTION OF THE EU

Official attitudes towards the EU continue to be very positive. Closer relations with the EU has continued to be the *leitmotiv* of the government and recent achievements in enhancing these relations are recognised as being one of the main achievements of the current leadership. The official policy in favour of EU integration has unanimous support from the coalition. Obligations towards Europe, and notably obligations linked to the Stabilisation and Association Agreement, are used as effective leverage to push internal reform.

The positive attitude towards the EU and its policies is not only found in the political and administrative elite but also in public opinion. The Croatian Ministry of European Integration conducts regular (twice a year) public opinion surveys to assess the general public's knowledge about the European integration process, and to identify the best means and optimal channels of supplying the information on EU integration that public needs. The last public opinion poll, conducted in December 2001, showed encouraging results. A positive view towards the EU, as well as of the association of Croatia, with the EU has remained high, at 77% of those polled. The same survey showed that more than 80% believe that the SAA will have positive impact on Croatia.

The Government recently adopted a communication strategy aimed at informing the public about Croatia's European integration process. The Government has given the MEI the mandate to coordinate information activities on European integration. Government priorities in the area of information include an intensification of the provision of general information about the EU and Croatia-EU relations, as well as EU integration. The

overall goal of the information policy is to acquaint civil servants, decision makers, all relevant opinion shapers, and the general public, with the EU integration process and the requirements of the EU, in particular by providing information about those Government policies which are specifically tailored to EU integration.

Media coverage of EU-related events is high and generally favourable. Visits by European politicians always attract high coverage. However information in the press is sometimes inaccurate and based on unfounded speculations. The media has, as a consequence, occasionally contributed to misunderstandings, partial perception and manipulation of public opinion on particularly delicate issues such as political conditionality, especially Dayton obligations and regional co-operation. The situation illustrates that there is a need for information and training of journalists on EU issues.