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## ACRONYMS AND ABBREVIATIONS

ACM	Association of Cities and Municipalities	HPB	Croatian Postal Bank
AKs	Agro-kombinats	IACS	Integrated Administration and Control System
AMS	Aggregate Measurement of Support	IAS	International Accounting Standards
APMC	Agency for the Protection of Market Competition	IFIs	International Financing Institutions
ARD	Agency for Rural Development	IP	Intellectual Property
PSE	Producer Support Estimate	IPPC	Integrated Pollution Permit and Control Regulation
CCBS	Croatian Central Bureau of Statistics	IPPC	Integrated Pollution Permit and Control Regulation
CAP	Common Agriculture Policy	JANAF	Jadranski Naftovod d.d.
CAP	Country Action Plan	MBIs	Market Based Instruments
CCE	Croatia Chamber of Economy	MFN	Most Favored Nation
CDA	Croatian Securities Depository Agency	MJALSG	Ministry of Justice, Administration and Local Self-Government
CEECs	Central and Eastern European Countries	MMATC	Ministry of Maritime Affairs, Transport and Communication
CEFTA	Central European Free Trade Agreement	MoES	Ministry of Education and Sports
CEM	Country Economic Memorandum	MOJ	Ministry of Justice
FDI	Foreign Direct Investment	MoST	Ministry of Science and Technology
FIAS	Foreign Investment Advisory Service	MOU	Memorandum of Understanding
CERC	Croatian Energy Regulatory Council	NEAP	National Environment Strategy
CGG	Consolidated General Government	NGOs	Non-governmental Organizations
CNB	Croatia National Bank	NSC	National Steering Committee
COM	Council of Ministers	OECD	Organization for Economic Cooperation and Development
CPF	Croatian Privatization Fund	PBZ	Privredna Banka Zagreb
CROSEC	Croatian Securities Commission	PCO	Pan-European Cumulation of Origin
CSIPO	Croatian State Intellectual Property Office	PIFs	Privatization Investment Funds
DASB	State Agency for Deposit Insurance and Bank Rehabilitation	PSE	Producer Support Estimate
EAs	Europe Agreements	R&D	Research and Development
EPL	Employment Protection Legislation	SAA	Stabilization and Association Agreement
EU	European Union	SEECs	South-Eastern European Countries
FTAs	Free-Trade Agreements	SIGMA	Support for Improvement in Governance and Management
GHG	Greenhouse Gases	SOEs	State-owned Enterprises
HAC	Hrvatske Autoceste		
HBOR	Croatian Bank for Reconstruction and Development		
HEP	Hrvatska Elektroprivreda d.d.		

TERFN	Trans-European Rail Freight Network	UNDP	United Nations Development Programme
TINA	Transport Infrastructure Needs Assessment	USAID	United States Agency for International Development
TPA	Third-Party Access	VET	Vocational Education Training
TTFSE	Trade and Transport Facilitation in Southeast Europe Program	VSE	Varazdin Stock Exchange
UCTE	Union for the Coordination of Transmission of Electricity	WBES	World Business Environment Survey
ULC	Unit Labor Costs	WTO	World Trade Organization
		ZSE	Zagreb Stock Exchange

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# 1. MOTIVATION AND OBJECTIVES – THE CHALLENGE OF EUROPEAN INTEGRATION

## A. THE STABILIZATION AND ASSOCIATION AGREEMENT AND THE PROCESS OF EUROPEAN INTEGRATION

1.1 On October 29, 2001, Croatia signed the Stabilization and Association Agreement (SAA), marking the first comprehensive contractual relationship between Croatia and the European Union (EU). The SAA evolved out of the Stabilization and Association Process and provides the framework for closer relations between the EU and the five South-Eastern European countries (SEECs).<sup>1</sup> Pending the entry into force of the SAA (which requires ratification of all EU member countries), an Interim Agreement covering trade and trade-related matters entered into force on March 1, 2002.<sup>2</sup> The SAAs are similar in many ways to the Europe Agreements (EAs) that were signed between the EU and the 10 Central and Eastern European countries (CEECs) prior to their becoming candidates for EU accession (Box 1.1). For the 10 CEECs, the signing of the EAs

### **Box 1.1: Comparison between the Stabilization Association Agreement and the Europe Agreement**

Both the Europe Agreements (EAs) and the Stabilization and Association Agreements (SAAs) cover trade liberalization, political dialogue, mutual right of establishment of firms, supply of services, liberalization of capital flows, movement of workers and various forms of economic, financial and technical cooperation. However, the SAAs differ from the EAs in the political pre-conditions that have to be met prior to starting negotiations on the agreement (in Croatia's case, this was met after its Parliamentary and Presidential Elections in early 2000), and in the more detailed provisions on political matters and harmonization of legislation as well as the firm obligations for regional trade cooperation. The SAAs and the EAs also differ in another way. While countries with EAs become eligible for EU accession once they meet the "Copenhagen" criteria (see below), countries with SAAs are only "potential candidates" for EU accession. Hence, there is no formal commitment by the EU to invite SAA countries to become candidates, but there is the desire to establish some type of association whose parameters would be decided in the future.

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<sup>1</sup> In addition to Croatia, these are Bosnia and Herzegovina, Federal Republic of Yugoslavia, former Yugoslav Republic of Macedonia and Albania. The European Commission classifies these countries as the Western Balkans.

<sup>2</sup> The SAA was ratified by the Croatian Parliament and European Parliament in December 2001. The Parliaments of Austria, Ireland, Denmark, German, and Spain have subsequently ratified the SAA.

marked the beginning of their integration with the EU.<sup>3</sup> The impact of the EAs has gone well beyond trade access. Even more important perhaps has been the process of bringing laws, institutions and policies in line with the EU's *acquis communautaire*.<sup>4</sup> This has set the stage for a massive inflow of FDI towards the CEECs and their integration in the trade, production and financial web of EU firms.

1.2 The trade liberalization component of the SAA (and Interim Agreement) can be viewed as part of a broader regional integration initiative. A free-trade area is emerging across much of Europe as trade barriers are removed between EU member, accession, and candidate countries, as well as countries from the EFTA and CEFTA blocks and the other SEECs. The simultaneous liberalization of trade in most countries of the region instrumented through Free-Trade Agreements (FTAs)—Croatia has already signed 35 of them over the last two years—can have potentially strong dynamic effects on investment and trade flows through integration into an expanded “single market.” This presents Croatia with a unique opportunity to become geographically attractive for foreign direct investment (FDI) that can simultaneously foster regional integration and ensure fast convergence to the EU.

1.3 The challenge thus is to create the conditions that will attract such investment; these conditions can broadly be categorized as (a) stable, progressive and predictable laws and institutions (including well-established property and creditor rights, a well-functioning judiciary and adequate law enforcement); (b) efficient factor markets (flexible labor markets, adequate skills for innovation driven growth, and deep financial markets); (c) macroeconomic and financial stability; (d) social and environmental sustainability; (e) effective integration into European infrastructure networks; and (f) a dynamic business-oriented environment which facilitates the production of high value added goods and promotes the adoption of efficient processes and innovative technologies.

1.4 The *acquis communautaire* provides the benchmark for the laws, regulations and institutions which will be conducive to the creation of the conditions for investment and growth described above. In addition, the SAA can also play a very constructive role in

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<sup>3</sup> Tang, Helena, *Progress Toward the Unification of Europe*, the World Bank, 2000.

<sup>4</sup> The *acquis* consists of: the content, principles and political objectives of the Treaties (including those of the Treaty of Amsterdam); legislation adopted pursuant to the Treaties, and the case law of the Court of Justice; statements and resolutions adopted within the Union framework; joint actions, common positions, declarations, conclusions and other acts within the framework of the common foreign and security policy; joint actions, joint positions, conventions signed, resolutions, statements and other acts agreed within the framework of justice and home affairs; and international Agreements concluded by the Community and those concluded among themselves by the member states with regard to Union activities. The *acquis communautaire* consists of about 80,000 pages, and it is continually changed, improved and increased as the EU moves ahead. The concept of the *acquis communautaire* permits the EU to maintain its cohesion and allows deepening its normative and institutional development, despite the increasing number of members. The *acquis* is an indivisible whole of the European integration. New members need to accept and implement the *acquis*. Countries in accession must accept the *acquis* to safeguard the achievements and integrity of the EU. Exceptionally, temporary derogations and transitional periods may be agreed to allow gradual harmonization where exceptional difficulties are confronted.

helping to accelerate the reform agenda by smoothing otherwise difficult to reconcile policy differences and conflicting interests. But the externalities of the SAA and prospective membership do not end there. The enlargement of the EU single market to the East and to the South will help to consolidate the peace and democratization process—a key ingredient to regional stability—while extending opportunities for economic growth and prosperity both to new entrants and current EU members.

1.5 *If the experience of the CEECs is any guide, European integration under the SAA will be key for Croatia's long-term development projects.* The experience of the CEECs and the cohesion countries before them further indicates that only those countries which have undertaken the necessary economic, political and institutional reforms can accrue some of the key benefits of European integration such as increased trade flows and FDI.<sup>5</sup> It is in this context that *the proposed CEM will focus on Croatia's progress in reforms towards completing its transition to a market economy and the reforms that are necessary to promote sustainable economic growth.* Given the Croatian Government's aspiration to integrate with the highly competitive European market, this requires *looking into what Croatia would need to do to enhance its competitiveness with respect to the rest of Europe.*

1.6 This Report places significant focus on the sequencing of reforms and *investments required by the SAA and convergence to the *acquis communautaire*.* This implies identifying and assessing inter-temporal costs and benefits for Croatia of the required reforms/investments in order to prioritize those which would bring the greatest benefits and lower costs up-front. As economic convergence with the EU advances, so will the economic rationale to engage in the more expensive investment programs and/or reforms which correspond better to highly developed economies. The Report also discusses and focuses on *efficient instruments* to meet EU standards. This implies increased use of market-based instruments with greater private sector participation (in infrastructure, environment and education) and enhancing the role and proper functioning of factor markets (labor and financial).

## **B. GROWTH STRATEGY IN A “NUTSHELL”**

1.7 The core of the diagnosis for Croatia is that inadequately established property and creditor rights, a poorly functioning judiciary and soft budget constraints (particularly on public enterprises) account for limited enterprise restructuring and relatively poor job and new business creation. These are the main obstacles to fast and sustainable growth in Croatia. Job creation has also been hindered by stringent employment protection legislation. With unemployment at 15 percent and no definitive trend towards reducing this rate, unemployment remains a key social and economic concern. Addressing these constraints requires legislative initiatives but, more importantly, public administration reform to ensure the effective implementation and enforcement of such legislation. A modern and efficient public administration would be critical also to develop institutional

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<sup>5</sup> *Ibid.*

capacities necessary for the implementation of Croatia's commitments under the SAA, including as concerns the approximation of the *acquis*.

1.8 Other key inputs for fast and sustainable growth are skilled labor and high-quality and cost-efficient infrastructure services. Free trade achieved under the SAA will help to ensure the supply of cost-efficient intermediate and capital goods and will place strong competitive pressures on Croatian companies. Thus, the importance of higher-education reform and market-oriented infrastructure institutions as envisaged in EU Directives including the institutional development of key regulators and the strengthening of the competition agency. The highly competitive European environment require, in particular, well focused training and higher education programs that offer firms qualified staff with adequate skills for an innovation-driven knowledge economy. In such an economy, research and development (R&D) would play a key role. R&D at the firm level needs to be encouraged and research centers should be redesigned to tap synergies with private firms in the high-tech spectrum. Similarly, market-oriented energy, transport and communications would be crucial to enhance competitiveness and to foster integration with the European economy while opening vast opportunities for private sector development and FDI.

1.9 Even with a more employment-creating type of economic growth, parts of the population, in particular the long-term unemployed, could still be excluded from employment opportunities for lack of appropriate skills and other reasons. This Report does not address these social dimensions directly, as they have been dealt with recently in the Poverty Assessment and the Public Expenditures Review.

1.10 Throughout the late 1990s the Croatian economy was characterized by the dominance of large unstructured enterprises in an economy with insufficient competition. As with the other countries of former Yugoslavia, where prior to transition enterprises were predominantly socially-owned,<sup>6</sup> the privatization process undertaken by Croatia gave overwhelming preference to manager and employee buy-outs. This mode of privatization has not been conducive to enterprise restructuring, and has discouraged foreign investment. The dominance of these large enterprises in a non-competitive environment has also resulted in weak employment growth which disproportionately penalizes the poor since they are the least able to exploit limited opportunities. The growth strategy proposed here aims precisely at fostering enterprise restructuring, SME creation, labor mobility and enhancing skills. The implication is that while the proposed reform agenda is not explicitly targeted at lowering relative poverty, it would *indirectly* contribute to this objective.

1.11 The proposed microeconomic reforms must be embedded in a stable macroeconomic and financial framework. In Croatia, this will imply addressing **fiscal issues**, particularly the public sector wage bill, pension and health costs and different forms of state aid in general. A stable macroeconomic framework would also imply

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<sup>7</sup> See Slovenia: Economic Transformation and EU Accession, the World Bank, 1999, Chapter VI, for a description of socially-owned enterprises.

**financial stability issues**, especially prudential regulations and banking supervision to prevent fast credit growth and potential exchange rate volatility from eroding the quality of the portfolio. This Report proposes that a more rapid pace of fiscal adjustment would be important to dispel concerns of debt sustainability. In general, reducing the pro-cyclical biases in fiscal and financial sector policies and institutions will help to make Croatia less vulnerable to the kind of shocks to which it has been exposed over the last decade.

1.12 While the reform agenda recommends the *rapid* adoption and implementation of various policies and institutions embodied in the EU acquis, there are two areas, agriculture and the environment, where a different kind of strategy is proposed. In the case of the environment, a sequence of implementation is proposed that would strategically phase in investments, giving priority to those where the tangible benefits would accrue over the short to medium term. Croatian policy makers might be well advised to phase in over time only some of the measures necessary to raise air quality standards. A similar strategy is proposed as well for some water supply and solid waste standards. The environment reform agenda should be driven also by efficiency considerations aimed largely at introducing market mechanisms for pollution mitigation and inducing greater private sector participation to alleviate the budget burden. In agriculture, the recommendation is to align existing instruments with World Trade Organization (WTO) and Common Agricultural Policy (CAP) requirements, but to reduce support levels **below** those currently available under the CAP. Compared to the present situation, this scenario would speed up growth and leave the poor better off due to lower food prices and the higher share of food in their consumption basket. Furthermore, there is an urgency to accelerate the pace of institutional and human capital development in both the environment and agriculture sectors. These are the reforms which will take longer to implement. The environment and agriculture institutions needed to run such complex policies will require a significant improvement in the capacity of the Government to effectively administer them.

### C. REFORM AGENDA – CROSS-CUTTING SECTORAL ISSUES

1.13 This Report emphasizes the legal, institutional and policy dimensions of the reform agenda. Perhaps the most important cross-cutting sectoral issue is the need to strengthen the human and institutional capacity of Croatia’s public administration and judiciary to implement and enforce the proposed laws, regulations and policies and to efficiently steward public resources. Limiting efforts to transposing EU regulations “pro-forma” would likely deprive Croatia of the economic and social benefits that such policies would bring about if they were effectively implemented. Too often laws and regulations exist but are not applied due to lack of understanding with respect to the purpose and application of the law, lack of incentives for compliance and/or enforcement, politicization of civil servants, etc. Similarly, a civil service has not demonstrated a capacity to strategically prioritize investments and reforms nor properly discriminate least-cost and more efficient market-compatible solutions to the provision of public goods. This lack of capacity is very costly both fiscally and economically.

1.14 Clearly, public administration reform is urgently needed. The public sector ought to prioritize the efficient working of basic systems and capacities, for example, to administer the budget and evaluate alternative policies. A more professional and de-politicized civil service needs to be developed along with other administrative reforms which facilitate better coordination in the process of policy making and the structure of government itself. In particular, there is an area of public administration which currently hampers enterprise restructuring, financial market development and the investment climate in general: the poor functioning of the judicial system. Modernization of courts and training of commercial judges is crucial for an effective bankruptcy regime that, in turn, can secure property and creditor's rights. Such reform would bolster investment and FDI crucial both for growth and European integration.

1.15 Another (related) cross-cutting issue is the Government's propensity to "protect" jobs through expensive employment protection programs, e.g., high severance compensation, or through subsidies to loss-making State-owned enterprises (SOEs). The problem with labor-protecting legislation is that, beyond certain limits need for social protection, it often ends up hindering the demand for labor thus exacerbating unemployment, hampering enterprise restructuring and curtailing job creation. The proposed amendments currently in Parliament would substantially address many current deficiencies in Croatia's labor market regulation. Similarly, the problem with the privileges awarded to SOEs, in particular shipyards, railways and agro-processing firms (both through explicit transfers and through exemptions from fiscal obligations, soft loans and discriminatory protection) is that, while they may appear to protect jobs, they tend to have precisely the opposite effect. By delaying SOEs' restructuring and by preventing the development of a level-playing field for private investment and diverting scarce resources to loss-making enterprises, these policies discourage new firm entry, existing firms' expansion and sustainable job creation. The EU *acquis*, (particularly the State Aid Directive), aims precisely to limit this kind of distortion.

1.16 Education reform is could also strengthen Croatia's labor market. The Central Government has a critical role to play. For example, the State now controls inputs and processes while accountability for learning outcomes is the responsibility of the schools. The reverse should happen. The State should hold schools accountable for learning outcomes and give them the freedom, and, as needed, the technical support, to figure out how to produce them. In particular, Croatia should structure its tertiary education system flexibly to let institutions, faculties, students, and supplier markets adapt to change.

1.17 This is linked to a third important cross-cutting issue - fiscal reform. There is a need to emphasize both the macro and micro dimensions of fiscal adjustment or lack of it. On the macro dimension, the concern is macroeconomic stability. Insufficient adjustment could set the economy in a vicious circle of high public debt-low private investment and growth with risks of financial instability. On the micro dimension, fiscal discipline is the basis for ensuring rules of the game that are stable and transparent and which thus can attract investment based on the merit of the business. Without fiscal discipline, incentives to invest in the production of goods, factors, services and human capital are at a minimum distorted and most likely driven by unsound economic and financial

calculations. An over-extended public sector, Croatia has one of the largest public sectors in Europe, is a burden on the economy and impedes the transition to a market economy.

1.18 Another cross-cutting theme, again linked to previous ones, is the lack of transparency and economic information on the social impact of some of the most distortionary policies currently in place in Croatia, particularly agriculture. Not only do these policies act as a drag on market-oriented reforms, they are also detrimental to low income citizens. Croatia ought to be aware that the social cost of some interventionist agricultural policies are “luxuries” which a country like Croatia can ill afford.

1.19 Finally, there is a cross-cutting sectoral issue with vast implications for investment and the business environment in general: the timely development of an efficient land cadastre and property registry system. Full coverage by the land cadastre and property registry system are an absolute priority. This is essential not only to secure titles of property and thus property rights and the investment climate in general. Such a reform of the land cadastre and property registry would also facilitate the extension of (collateralized) credit by banks to both new and expanding SMEs, promote investment and land consolidation in agriculture, attract FDI into “greenfield” operations, facilitate investment in new tourist facilities, accelerate the process of privatization, promote private savings invested in real property and financial instruments backed by real property, and widen the scope of eligible financial instruments to pension funds and institutional investors. In view of the potential to mobilize investment and job creation, this reform is thus a key priority of Croatia on its road to sustained growth.

#### **D. STRUCTURE OF THE REPORT**

1.20 The rest of this Report is organized as follows:

1.21 Chapter 2 describes recent macroeconomic developments and presents key fiscal issues, in particular, the requirements for debt sustainability. It also provides a fiscal assessment of the reforms proposed in this Report and measures that might be needed to adopt EU standards and policies. Alternative scenarios of convergence to sustainable fiscal outcomes are examined. The fiscal framework is critical for deciding on the prioritization and sequencing of reforms. Croatia’s high public expenditure, large public sector deficit and debt sustainability concerns pose a major obstacle for private sector development, European integration and sustainable growth.

1.22 Chapter 3 brings into focus the impact of regional trade liberalization on Croatia’s economy. The network of free trade agreements (FTAs) comprises not just the EU—through the SAA—but also FTAs with CEECs, CEFTA countries and other SEECs. The chapter aims to illustrate the incentives and challenges of entering the emerging free trade area which spans much of Europe. It also provides an assessment of impacts and policies which may be adopted to ensure a smoother and more effective regional integration through increased FDI flows.

1.23 Chapter 4 analyzes the weaknesses of the Croatian public administration. This is the single most important bottleneck for advancing reforms. The chapter analyzes the

requirements of a modern state and proposes an agenda to reform the central administration, to modernize the civil service and to strengthen policy management. A brief discussion on the strengthening of regional and local self-government is also included along with an assessment of how all these efforts should be integrated with the overall reform and how reforms should be sequenced.

1.24 Chapter 5 reviews the status of the enterprise and financial sectors and identifies the key legal, regulatory and institutional barriers to enterprise restructuring, privatization and financial sector development. The unresolved issue of land and property ownership and proposals to remedy it occupy a prominent part of the chapter. The chapter also reviews other key factors that will contribute to improve the investment climate. It also describes policies and regulations that will be conducive to greater financial deepening and increased financial stability.

1.25 Chapter 6 analyzes how laws, policies and institutions can be redesigned to increase the efficiency of labor markets and thus, to facilitate enterprise restructuring and job creation. This requires, for example, revising employment protection legislation as well as collective bargaining arrangements. Consistency with the SAA and the EU *acquis* is also addressed. The chapter concludes with an analysis of proposals to revamp higher level education and research policy in order to create the skills and foster the synergies that are required for innovation-driven economic growth.

1.26 Chapter 7 reviews progress made so far and reforms that will be necessary for compliance with the requirements of the SAA in the energy sector and in the transport sector. It focuses on the institutional and regulatory changes that are needed to foster private sector participation in the provision of infrastructure services. Where possible, the likely costs and benefits of the Government investment plans are examined, and recommendations are made to minimize the costs and maximize the benefits of such investments with a view of what is required for the SAA.

1.27 Chapter 8 describes the state of the environment in Croatia and provides estimates of the investment and recurrent costs involved in adopting EU environmental standards. Such investment needs are quantified under different reform scenarios and, under certain assumptions, are allocated over time. The use of market-based instruments, private concessions and cost-benefit analysis is extensively applied to minimize the budgetary burden and increase overall efficiency of investments. Finally, the consistency of SAA requirements with the National Environment Action Plan is assessed and a strategy for investment and institutional reforms is proposed.

1.28 Chapter 9 reviews the status of the food and agriculture sectors and progress on the main reforms launched so far by the Government. The impacts on farmer's incomes and on welfare of alternative policy strategies is then analyzed. Such policies include, in particular, the adoption of the Common Agricultural Policy of the EU. Adoption of such policy will represent a welfare improvement vis-à-vis the current situation. During the transition, however, it is advisable to reduce the level of intervention in order both to foster competition and improve welfare. The chapter assesses other critical issues for

European integration and concludes with proposals to accelerate reforms in agro-processing and to conform with EU institutions and the regulatory system.

## 2. MACROECONOMIC AND FISCAL STRATEGY

2.1 Macroeconomic developments in the 1990s were the reflection of national challenges, policy strengths and weaknesses and external shocks in the period. Consolidating itself as an independent nation led to a war with all the associated social, fiscal and economic costs; output collapsed by at least one-third. Peace was at least as expensive in terms of investment for reconstruction, the cost of mitigating its social consequences and overcoming hyperinflation through a very stringent stabilization program. As output recovered, fiscal laxity also crept in. Wage and credit growth also turned unsustainable, but the underlying weaknesses in the economy became apparent only after the Russia crisis in 1998 and even more after the conflict in Kosovo in 1999 led to sharp contraction in capital inflows and tourism.

2.2 The new Government elected in early 2000 led Croatia out of the recession and opened the economy to global markets through WTO and CEFTA memberships, improved cooperation with SEEC neighbors and negotiation of the SAA with the EU. These moves have opened up a vast new agenda of reform, aiming at strengthening the economy's capacity to compete in European markets while pursuing a prudent fiscal policy that can simultaneously redress past excesses and make room for large the investments which European integration may require.

2.3 This chapter briefly reviews the most important macroeconomic developments (Section A) and fiscal issues (Section B). It then addresses the fiscal requirements of debt sustainability (Section C) and proposes a medium term fiscal strategy (Section D).

### A. MACROECONOMIC DEVELOPMENTS

2.4 Upon gaining independence in 1991, Croatia was plunged into the hostilities that beset the countries of the former Yugoslavia, and suffered a large output decline and hyper inflation that reached 1,500 percent in 1993 (Table 2.1). Following cessation of the hostilities, Croatia embarked on a stabilization program in October 1993 that included anti-inflationary monetary and fiscal policies, liberalization of the foreign exchange market, realignment of prices of public utilities and control of public sector wages. The cornerstone of the program was a drastic fiscal tightening and the introduction of a new exchange rate regime which set an upper intervention rate. These policies quickly stabilized the exchange rate<sup>7</sup> and brought down monthly inflation to nearly zero at the

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<sup>7</sup> The intervention rate on the depreciation side (vis-à-vis the German DM) was announced for the first three months of the program while no intervention rate was announced on the appreciation side. The intervention rate was announced for a depreciation of about 20 percent from the October 1, 1993 exchange rate followed by depreciations of 3.5 and 3.3 percent for November and December. In fact, the exchange rate remained at the depreciation intervention rate for just a few days before a process of nominal appreciation began. By end-November, the exchange rate nominally appreciated by nearly 15 percent



2.6 Imports had been subdued during the war due to extremely low domestic demand. This resulted in a current account surplus during most of the war period. However, with post-war reconstruction financed by capital inflows, the current account abruptly shifted from a surplus of 4.9 percent of GDP in 1994 to a deficit of 7.5 percent of GDP in 1995. Debt financing of the current account deficit (Table 2.2) was facilitated by favorable assessments of Croatia's credit worthiness by international financial markets which paved the way for Croatia's access to foreign financing at favorable terms.<sup>8</sup> In light of Croatia's relatively low level of external debt (about 20 percent of GDP in 1994 and 1995) and following two successful debt rescheduling operations with the Paris Club (1995) and the London Club (1996), all three major credit rating agencies upgraded Croatia's credit rating to the lowest level of investment grade by early-1997.<sup>9</sup>

2.7 Capital flows fed a deposit surge which, combined with bank restructuring and privatization, facilitated a supply-driven domestic credit boom. The growth of credit to households peaked at an annual rate of 94 percent at the end of 1997 (from a low base), while credit to enterprises rose by 40 percent. The bulk of these loans were denominated in foreign currency or indexed to foreign currency. Rapid credit growth, rising public expenditure and strong wage growth<sup>10</sup> financed an unsustainable expansion in private consumption and investment in 1997. Real GDP growth reached 6.8 percent, but was accompanied by soaring imports which led to the double-digit current account deficit in 1997.

2.8 Pro-cyclical fiscal policies turned Croatia's fiscal surplus into a deficit in the range of 1.5 percent to 3 percent of GDP between 1995 and 1998. General Government expenditure, driven by reconstruction activities as well as increases in wages and social spending, rose from 44 percent of GDP in 1994 to 57 percent of GDP in 1999. The Croatian authorities were reluctant to tighten fiscal policy or rein in fiscal expenditures.

2.9 Instead, in 1998, monetary policy bore the brunt of the policy tightening. While these policies helped to reduce the current account deficit to 7 percent of GDP, credit growth was rapidly reined in and a recession ensued in late 1998. The recession was exacerbated by the Russia crisis and the outbreak of the armed conflict in Kosovo in May 1999. The exchange rate, which had traded within a narrow band since the 1993 stabilization program, depreciated by 12 percent between mid-1998 and mid-1999. The depreciation proved to be a difficult burden for many debtors who had borrowed in foreign currency (or in foreign currency indexed loans) but whose income was

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<sup>8</sup> Croatia issued 3 eurobonds in 1997 of US\$300 million, DM 300 million, and ATS 700 million and one eurobond in 1998 (Ptas 15 billion). The bonds had maturities of 5, 7, 5, and 3 years, respectively. All bonds were issued at spreads of less than 100 basis points over sovereign benchmark bonds.

<sup>9</sup> The Paris and London Club agreements resolved which parts of the external debt of the former Socialist Federal Republic of Yugoslavia (SFRY) would be allocated to Croatia and how such payments would be rescheduled. The Paris Club allocated US\$1,087 million to Croatia which included debts of the former SFRY which were contracted by legal entities of the Republic of Croatia as well as 28.5 percent of debt contracted or guaranteed by the former SFRY which could not be directly attributed to successor countries. The London Club allocated US\$1,462 million to Croatia.

<sup>10</sup> Consumption was also fueled in 1997 by the one-off effect of expectations of the introduction of the VAT in January 1998.

predominantly in kuna. The contraction in GDP in 1999 led to lower tax revenues and higher subsidies and transfers, resulting in an escalation of the fiscal deficit to 8.2 percent of GDP. Public debt reached 54.1 percent of GDP at the end of 1999, a substantial increase over the 1994 ratio, raising concerns on debt sustainability.<sup>11</sup>

**Table 2.2: Capital Flows, 1993-2001 (in US\$ million)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
A. Current Account	637	711	-	-956	-	-	-	-439	-617
B. Capital and Financial	-389	-262	1096	1995	2652	1469	2373	1203	1160
B1 Capital	0	0	0	16	21	19	25	21	133
B2 Financial account, excl.	78	481	1539	2512	3058	1601	2726	1764	2340
1. Direct	102	110	109	486	347	835	1413	1077	1368
1.1	-19	-7	-5	-24	-186	-98	-45	0	-144
1.2 in	120	117	114	511	533	932	1458	1077	1512
2. Portfolio investment	0	11	5	628	577	15	570	722	716
2.1 Assets	0	1	0	6	11	0	0	0	-6
2.2 Liabilities	0	10	5	622	566	15	571	722	722
3. Other Investment	-24	360	1425	1398	2134	752	743	-35	256
3.1 Assets	-166	-16	419	794	171	349	-118	-848	311
Of which currency and deposits on non government	45	174	887	1381	494	-15	0	0	1893
3.2 Liabilities	142	376	1006	603	1963	403	860	813	-55
Of which long-term loan disbursements to authorities and	4	125	112	350	220	248	297	235	167
Of which long-term disbursements to and other	150	174	306	494	1595	1487	1360	1177	925
B3 Reserve assets	-467	-743	-443	-533	-428	-152	-378	-582	-
C. Net Errors and	-249	-449	331	-	-139	-16	-975	-764	-543

Source: CNB.

2.10 The weak economy and the drying up of repatriated deposits (Table 2.2) exposed the underlying insolvency of a group of aggressively growing mid-sized private banks.<sup>12</sup> Many of these banks had attracted foreign currency deposits by offering high interest rates and then engaged in increasingly riskier lending, often to “insiders” and loss-making enterprises. As a result, these banks suffered from a rapid build up in non-performing loans. A liquidity crisis at one of the largest banks triggered a crisis of confidence in these fast growing banks.

<sup>11</sup> The fiscal stance in the years 1997 and 1998 is likely to have been much more expansionary than the fiscal data implies. Many contingent liabilities were built up in these years through government guarantees on debt incurred by chronically loss-making industries such as shipbuilding and AKs. Since these guarantees have a high likelihood of being called, their issuance in these years was an indirect subsidy which is likely to have had a stimulatory effect on aggregate demand. The reference to public debt includes central government domestic and external debt, plus public guarantees (both financial and performance guarantees though excluding intergovernmental guarantees), plus all short-term liabilities of the health sector and other public sector arrears and direct debt of all local government units.

<sup>12</sup> The total number of banks grew rapidly until 1996, the number of large and small banks did not change significantly, but the number of medium-sized banks grew from six in 1993 to 21 in 1998 while their total assets from US\$140 million to US\$1.4 billion. See Vleimir Sonje and Boris Vujcic, “Croatia in the Second Stage of Transition (1994-1999),” *Croatian National Bank Working Papers*, December 1999. See also the Financial Sector Background Paper.

2.11 The CNB intervened in 17 distressed banks, accounting for 17 percent of banking sector assets in 1998 and 1999.

2.12 Paralleling fiscal and financial weaknesses, merchandise exports stagnated at about US\$4.5 billion throughout the mid- and late-1990s. Unlike other CEECs, there was very little change in the composition of merchandise exports and exports to the EU actually declined. While part of the explanation for this poor performance was the lack of preferential trade status with the EU and the lack of participation in the Pan-European accumulation of rules of origin, limited enterprise restructuring and investment in new technology appears to have been a more important reason.<sup>13</sup>

2.13 The Parliamentary and Presidential elections in early 2000 radically transformed Croatia's political landscape. The six-party coalition led by the social democrats had almost a two-thirds majority in Parliament. The new Government was quick to embark on a policy of integrating Croatia into international cooperative structures such as NATO's partnership for peace program and WTO membership. The Government also pursued policies to speed Croatia's integration into European institutions. Many bilateral free trade agreements have been signed as has a trade agreement with EFTA, and the SAA.<sup>14</sup> The new Government's economic strategy envisaged, *inter alia*, fiscal adjustment, wage restraint, and the implementation of structural reforms.

2.14 One of the more intractable challenges in Croatia has been high unemployment and low rates of job creation. Even during the period of rapid growth between 1994 and 1997, Croatia's unemployment rate remained stubbornly high at 10 percent. However, the economic recovery which has ensued in recent years has not been accompanied by commensurate employment growth and the unemployment rate has remained high at around 15 percent according to the generally accepted ILO definition (Table 2.1). Croatia's low employment rate is largely a reflection of a low rate of job creation. There are a number of reasons for the low rate of job creation: an unfavorable investment climate, high labor costs, an inflexible wage structure, and rigid employment protection legislation. Croatia's performance in terms of enterprise restructuring, privatization, attraction of greenfield FDI, and overall creation of an enabling environment for development of an internationally competitive private sector do not compare favorably to CEECs which are EU accession candidates. The lack of enterprise restructuring is the root cause of the poor financial performance of Croatian industry. This is illustrated by a net loss of 5.8 percent of GDP in 1999, as well as by the ballooning volume of enterprise arrears and growing payment's delinquencies.

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<sup>13</sup> The lack of competitiveness does not indicate an overvalued exchange rate (see Foreign Trade background paper and "Republic of Croatia: Selected Issues and Statistical Appendix," *IMF Country Report No. 02/179*, August 2002).

<sup>14</sup> Croatia was admitted to the WTO in 2000. As of June 2002, bilateral free trade agreements had been signed with: FYR Macedonia, Slovenia, Bosnia and Herzegovina, Hungary, the Czech Republic, the Slovak Republic, Poland, Turkey, and Bulgaria. Croatia signed a free trade agreement with EFTA in February 2001 and signed the SAA in October 2001. More than 90 percent of Croatia's trade is currently covered by preferential trade agreements.

2.15 Partly in response to these concerns, the Government which came to power in early 2000, began to implement a medium-term reform program. The authorities moved quickly to further restructure and privatize the banking sector and to liberalize its trade regime. Government introduced a multi-pillar pension system including a funded private second pillar mandatory for workers under 40 years of age. A number of reforms are in various stages of design and implementation to improve Croatia's investment climate. Budget constraints on state enterprises have been tightened, amendments to the Bankruptcy Law have been drafted, an action plan to reduce administrative barriers to investment is being implemented. Important amendments to the Labor Law aimed at increasing labor market flexibility have been submitted to Parliament. Key reforms are also being implemented in public expenditure management, Company Law (to protect property rights of minority shareholders), and implementation of an integrated cadastre and land registration system.<sup>15</sup>

2.16 In addition to structural reforms, the Government which took office in 2000 has changed the macroeconomic policy mix. Fiscal tightening (see Section B below) paved the way for lower interest rates. Business and consumer confidence improved with private consumption growth outpacing GDP growth in 2000-02. Net export's growth in turn—facilitated by the recovery in Europe, past real effective exchange rate depreciation and recovery in tourism—contributed to growth in 2000. In 2001, exports were further boosted by the granting of EU trade preferences. The recovery of private investment further contributed to the overall growth recovery in 2001 and 2002. Growth has recovered, averaging nearly 4 percent since 2000. The exchange rate has remained fairly stable while the inflation rate has been held to single digits. The banking sector recovered from its crisis and confidence in the banking system strengthened. Croatia's banking system, with the highest level of foreign ownership among transition countries, is well capitalized, profitable, and has significantly strengthened its risk management systems. Fiscal tightening and growth in tourism revenues helped reduce the current account deficit in 2000 and 2001 while international reserves soared to more than five months of imports.

2.17 Despite considerable progress in fiscal adjustment—public expenditure declined 5 percent of GDP in 1999-2002—the current account deficit soared in 2002 to nearly 7 percent of GDP. This deterioration in the external balance has its roots in a rapid and unsustainable credit expansion. Credit to the private sector grew by 30 percent in 2002 driven by fierce competition in the banking sector for market share and fueled by abundant liquidity and banks' easy access to foreign credit. Recognizing the potential threat to macroeconomic stability that such a credit-led overheating could lead to, the

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<sup>15</sup> Many of these reforms are being supported by World Bank projects. The reform program supported by the Structural Adjustment Loan, approved by the Board in December 2001, include: improvements in public expenditure management, increased labor market flexibility, strengthened market institutions and the competitiveness of the economy, improvements to the bankruptcy system and improvements for new business entrants. The Bank is supporting the pension reform through a loan designed to strengthen key institutions overseeing the pension system. The Bank is also supporting the first five years of implementation of the cadastre and land registration system.

CNB, in January 2003, announced new regulations designed to curtail credit growth and also imposed a new regulation on banks' net open positions.

2.18 Further reductions in the budget deficit—close to 5 percent of GDP in 2002—would help to facilitate a return of the current account deficit to more sustainable levels of about 3.5 percent of GDP. Further reductions in the budget deficit are also needed to place the public debt to GDP ratio on a firmly declining path. The ratio of public debt to GDP has risen every year from 1995 through 2001.<sup>16</sup> As the experience of various emerging countries has recently shown, even a moderately high public debt can become unsustainable if the exchange rate depreciates quickly especially if the marginal cost of borrowing jumps at the same time. The Government faces the challenge of continuing the process of fiscal adjustment begun in 2000 and in implementing structural reforms to ensure that enterprises adjust and the economy remains competitive to foster employment-generating growth.

## **B. FISCAL ISSUES**

2.19 The economic slowdown that started in 1999 reduced tax revenues (in particular, indirect taxes) and raised subsidies and transfers, resulting in an escalation of the fiscal deficit to over 8 percent of GDP on an accrual basis. The Government took steps to rein in the fiscal deficit beginning in 2000, focusing on expenditure cuts. Despite a 2 percent GDP drop in revenues between 1999 and 2002, the fiscal deficit fell from 8.2 to 4.8 percent of GDP due to larger expenditure reductions amounting to 5.3 percent of GDP.<sup>17</sup>

2.20 However, some of the expenditure cuts undertaken at the beginning of this political cycle were not sustained. For example, by 2002, the reduction in capital expenditure was nearly completely reversed by an extremely ambitious motorways' construction program. Social transfers that were partially rationalized during 2000 and 2001, have already experienced some reversal in 2002, while political pressures in the last year of the election's cycle might increase social transfers further in 2003. The broadest definition of the public debt (includes all outstanding guarantees and arrears) has already surpassed the level of 60 percent of GDP. At current levels of debt, a continuation of large primary fiscal deficits, on average 4.5 percent of GDP in 1999-2002, would lead to explosive debt growth in the absence of privatization revenues. Given that privatization revenues are likely to peter out within a few years, the Government should continue the process of fiscal adjustment launched in 2000 and bring primary fiscal balances closer to zero to ensure debt sustainability (Section C). Since tax pressure is already very high—nearly 10 percent of GDP higher than the average CEECs

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<sup>16</sup> The reference to public debt includes central government domestic and external debt, plus public guarantees (both financial and performance guarantees though excluding intergovernmental guarantees), plus all short-term liabilities of the health sector and other public sector arrears and direct debt of all local government units.

<sup>17</sup> In 2002, progress in fiscal consolidation was a bit more than the data suggest. The revenue losses from pension reform (the introduction of the fully funded private sector pillar implies a transitional deficit of about 1.3 percent of GDP) are largely neutral from a savings/investment perspective because the transitional deficits of the system are matched by increased private savings of the same magnitude.

and about 1.5 percent of GDP higher than the EU-15 average level—bringing the fiscal deficit down to a sustainable level would require further reduction in public expenditures. If the Government is to pursue its goal of eventual EU accession, the challenge of this fiscal adjustment would be greater by the need to phase in pre-accession adjustment costs and investment needs as well as investments related to the Government reform agenda underway. Together these expenditures are estimated to be about 5.8 percent of GDP per annum.

2.21 In order to identify the key issues at stake in the fiscal strategy, public revenue and expenditure trends in Croatia are reviewed and compared with trends in EU and accession countries.

### **Fiscal Trends<sup>18</sup>**

2.22 Public sector spending expanded throughout the armed conflict years (1991-1995) due to the need to introduce a new layer of government and, primarily, due to the resources allocated to the war effort (military expenses rose by 4.5 percent of GDP in that period) and housing reconstruction expenses (up 2.8 percent of GDP). As a result, Government spending grew from 39 percent of GDP in 1991 to 49 percent by the end of the war. This expansion was carried out despite a significant reduction of real pensions and public sector wages as a part of stabilization efforts to ease up fiscal pressures. Nonetheless, the public expenditure expansion continued in the post-war period, due to reconstruction activities and, foremost, due to the Government's inability to resist social demands aimed at rapidly recovering pre-war levels of consumption. In 1995-2002, as military expenses declined by 7.3 percent of GDP, social spending grew by an equivalent amount. And while reconstruction spending was unchanged, road construction rose 1.4 percent of GDP.

2.23 As a result, the size of the Government, as measured by the ratio of expenditures to GDP, expanded by more than 18 percentage points between 1991 and its peak in 1999. Croatia developed one of *the largest public sectors in the region*, in contrast to the trends in most EU accession economies where public sectors have in general contracted (Table 2.3).

2.24 In an attempt to revert this trend, Croatia started a fiscal consolidation process in 2000. With the support of an IMF Stand-By Arrangement, and as already mentioned, spending was reduced from 57.0 percent of GDP in 1999 to 51.7 percent in 2002. Fiscal adjustment was carried out through a reduction of public sector real wages (the real impact being visible only in 2001), other purchases of goods and services and capital expenditure in 2001 (the latter was reversed in 2002 due to the launching of an ambitious new motorways' construction program). However, despite improvements, Croatia remains an outlier in its public expenditure ratios. Croatia's public expenditure and its key components are still far higher than in most relevant comparator groups (Table 2.4):

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<sup>18</sup> The analysis has been done on Consolidated General Government accrual data, a broader definition than the one used in the PEIR (World Bank 2002a). It includes Central Budget, Extrabudgetary Funds, Road and Highway Agencies, Croatian Privatization Fund, Bank Rehabilitation Agency and Local Government.

total expenditures are over 10 percent of GDP higher than the average CEEC and cohesion countries and 7 percent of GDP higher than the EU 15; wages and salaries are over 60 percent higher than average CEEC; transfers and subsidies are at the high end within the comparator group; and capital expenditures are on average 2 to 3 percent of GDP higher than in comparative countries.

**Table 2.3: Consolidated General Government Expenditure in Selected Countries**

(% of GDP)	1991-93	1997-99	Difference	2001
Bulgaria	42.5	36.0	-6.5	38.7
<b>Croatia</b>	<b>37.7</b>	<b>51.7</b>	<b>14.0</b>	<b>53.5</b>
Czech Rep.	36.0	41.7	5.7	45.2
Hungary	51.7	48.0	-3.7	45.8
Poland	44.2 <sup>1/</sup>	44.9	0.7	46.0
Romania	36.8	34.8	-2.0	33.8
Slovenia	46.1	43.8	-2.3	44.5
Baltic countries <sup>3/</sup>	38.9 <sup>2/</sup>	40.0	1.1	35.8
EU 15 <sup>4/</sup>	51.4 <sup>2/</sup>	47.9	-3.5	46.4
Cohesion countries <sup>5/</sup>	45.0 <sup>2/</sup>	41.9	-3.1	40.7

1/ for 1994 only; 2/ for 1995 only; 3/ Estonia, Lithuania and Latvia; 4/ excludes net lending, 5/ Spain, Greece, Portugal and Ireland (excludes net lending).

Source: Government Finance Statistics, IMF; World Bank database.

**Table 2.4: Consolidated General Government Expenditures by Economic Classification 1995-2001 (% of GDP)**

	Croatia 2002*	Croatia 95- 01	Av. CEECs <sup>1/</sup>	Av.Cohesion <sup>2/</sup>	Av. EU- 15
Total Expenditure and net lending	51.7	52.8	41.0	40.1	46.9
Current Expenditure	44.1	45.9	36.7	35.7	43.2
Goods and services	22.1	25.2	16.7	16.7	20.2
Wages and salaries	11.0	11.9	7.2	11.3	10.6
Other G&S <sup>2/</sup>	11.1	13.3	9.0	5.4	9.6
Interest Payments <sup>2/</sup>	2.1	1.6	3.2	5.3	4.7
Subsidies and current transfers <sup>2/</sup>	19.9	19.1	16.8	13.7	18.3
Capital Expenditure <sup>2/</sup>	7.1	6.2	4.4	5.2	4.0
Net lending <sup>2/</sup>	0.5	0.7	3.2	-2.4	-2.1

\*Preliminary; 1/ Bulgaria, Czech R., Hungary, Poland, Romania, the Slovak Republic, Slovenia, and the three Baltic countries; 2/ for 1995-2000.

Source: GFS, IMF staff reports, World Bank database.

## Potential Sources of Expenditure Reductions

2.25 Based on a comparison with benchmark groups of countries of the functional classification of expenditures (Table 2.5), *there clearly is scope for significant spending reductions in public health, social security and transport*. In the case of health, and despite recent reforms, short-term savings are unlikely in view of the need to compensate for deferred maintenance costs during the last decade. Social security is far too high and

still increasing beyond the EU's average. The social welfare system suffers from inadequate targeting and overlapping of benefits for which rationalization could bring significant savings and improvement of services.<sup>19</sup> The system also allocates an important portion of benefits to war veterans - a type of spending not matched by other comparable countries. In the case of transport, an ambitious investment program into roads and highways (the spending peak will be in 2003 and 2004) drives public spending at 2.5 percent of GDP higher level than in comparable countries.

**Table 2.5: Consolidated General Government Expenditures by Functional Classification 1995-2001 (% of GDP)**

	<b>Croatia 2002*</b>	<b>Croatia 95-01</b>	<b>Av. CEECs<sup>1/</sup></b>	<b>Av. Cohesion</b>	<b>Av. EU 15</b>
Total expenditure	51.3	52.1	40.8	42.5	48.3
General public services	2.9	3.0	2.7		
Defense affairs and services	2.4	5.1	1.6	2.4 <sup>2/</sup>	2.0 <sup>2/</sup>
Public order and safety affairs	2.8	2.9	2.0		
Education affairs and services	4.8	4.0	5.2	5.0 <sup>2/</sup>	5.3 <sup>2/</sup>
Health affairs and services	7.1	7.2	5.0	5.1 <sup>2/</sup>	6.6 <sup>2/</sup>
Social security and welfare	18.7	16.8	13.4		
Housing and community amenity	3.1	3.8	2.0		
Recreational, cultural and religious affairs	1.3	1.3	1.1		
Fuel and energy affairs	0.0	0.0	0.3		
Agriculture, forestry, fishing, hunting affairs	1.1	0.8	1.3		
Mining, manufacturing, construction affairs	0.3	0.6	0.2		
Transport and communication	4.0	3.8	2.1		
Other economic affairs and services	0.6	0.6	1.1		
Expenditures n.c. by major group	2.1	2.2	2.7		

\* Preliminary; 1/ 1995-2000: Bulgaria, Czech R., Hungary, Poland, Romania, the Slovak Republic, Slovenia and the three Baltics countries; 2/ for 1997 only.

Source: GFS, IMF staff reports, WB database, staff estimate.

2.26 Although less significant in value, benchmarking with other groups suggests that there is also room for further downward reductions in defense spending. This could be done mostly through wages and salaries - in line with the government strategy, supported by NATO, of military staff downsizing.

### **Revenue Structure and Tax Administration**

2.27 The spending spree in the 1990s was made partly possible by significant revenue mobilization. In aggregate, tax collection expanded by 15 percent of GDP between 1991 and 1998 with tax revenues as a share of GDP reaching 47 percent of GDP in 1998.

<sup>19</sup> See for details World Bank (2001).

Revenue growth, in turn, was made possible by successive tax system reforms initiated in 1993 as well as by improvements in tax administration. The Government replaced old types of direct taxes and introduced new types of taxes, such as excises, surtaxes on the income tax. In 1998, a 22 percent single-rate VAT was introduced. The VAT rate is among the highest in Europe; the EU 15 average was 19.4 percent and the CEECs average 20.5 percent. On the other hand, the corporate income tax rate is among the lowest at 20 percent, compared to 25.2 percent in CEECs and 32.5 percent in EU 15. Both Croatia's revenue-to-GDP ratio and its tax-to-GDP ratios are the highest among CEECs and the Baltics, and are even above EU levels (Table 2.6).

2.28 Croatia has, by-and-large, been successful in lowering tax evasion which is estimated to represent between 5.5 percent and 7.5 percent of GDP.<sup>20</sup> Aside from tax administration per se, several factors have contributed to improve tax compliance: the introduction of the VAT and the reduction of payroll taxes to 37.6 percent in 1998, and the creation of a funded pension pillar (to the extent that perceived benefits improves incentives to contribute). There is, however, room for additional revenue gains from improving tax administration in the areas of local property tax<sup>21</sup> and payroll contributions where the introduction of a unified system of collection is expected to improve resource mobilization.<sup>22</sup>

2.29 With the implementation of a tax reform<sup>23</sup> in 2000, the Government aimed to lower the overall tax burden by 2.2 percent of GDP focusing primarily on direct taxes, especially profit and payroll taxes that seemed overly high compared to neighboring countries. In 2002, however, despite sizable reductions in the payroll tax (about 10 percent), it is still high compared to the EU average<sup>24</sup> and reportedly subject to substantial tax evasion. Reporting minimum wages or being informally employed appears to be a common practice among SMEs in Croatia. The Government has simultaneously decided to lower the effective personal income tax rate (including local surtaxes) from 17.8 percent to about 10 percent by further broadening personal income tax exemptions through very generous family allowances. Simultaneously, with the objective of increasing tax progressivity, the Government introduced the fourth marginal personal income tax rate of 45 percent starting from 2003. It should be noted, however, that the high-rate VAT is a socially regressive tax – unlike income tax, which depends on income

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<sup>20</sup> See Madzarevic-Sujster (2002).

<sup>21</sup> Currently, Croatia collects a tax on real estate transactions. Due to the poor state of affairs in the land registry and non-existence of the single property registry, the introduction of the modern property tax would need to be postponed until the preconditions for its assessment will be in place.

<sup>22</sup> Some preliminary information suggests that, in the first nine months of the application of the new unified payroll tax collection system through Treasury (collection of revenues) and REGOS (collection of data), compliance has improved 9 percent. Also, the new system has reduced the administration costs to businesses through the elimination of the number of forms that employers had to fill in order to pay the contributions and wages, and unifying them under one, so-called RS form.

<sup>23</sup> For details see IMF (2000).

<sup>24</sup> Payroll tax was reduced from 47.4 percent in 1994 to 37.7 percent in 2002, while labor cost as a percent of net wage decreased from 112.5 to 68.9 percent (calculation has been done on the official statistical data on net and gross wages; Tax Department data show even lower effective income tax rate in 2001 of 7.5 percent).

levels and is disproportionately borne by lower income population. Against the possible merits of some of these reforms stands the higher cost of administrating a more complex system with multiple rates and exemptions. Adding to this cost also is the introduction of tax incentives to attract investors and encourage employment.

**Table 2.6: Comparative Revenue Ratios, 1995-2001 Average (% of GDP)<sup>1/</sup>**

	Total Revenue	Tax Revenue <sup>2/</sup>
<b>Croatia</b>	<b>48.4</b>	<b>43.6</b>
Bulgaria	38.3	29.2
Czech Republic	40.0	36.5
Estonia	38.9	34.2
Hungary	45.8	38.1
Latvia	38.0	32.3
Lithuania	31.5	29.6
Poland	42.1	35.7
Romania	31.1	25.1
Slovak Republic	39.3	34.1
Slovenia	43.1	40.4
<b>CEE average</b>	<b>38.8</b>	<b>33.8</b>
<b>EU 15 Average</b>	<b>46.3</b>	<b>42.0</b>
<b>Cohesion countries</b>	<b>40.1</b>	<b>n.a.</b>

1/ Consolidated General Government, 2/ 1995-2002 for Croatia.

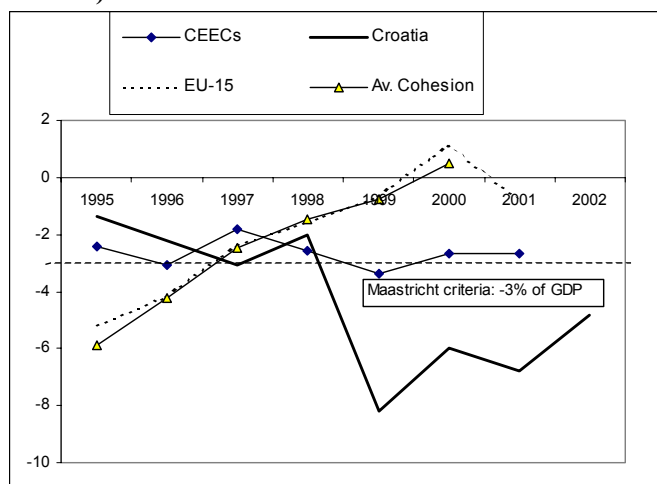
Source: IMF; Government Finance Statistics; International Financial Statistics; World Bank database and staff estimates.

### C. DEBT SUSTAINABILITY

2.30 Large levels of public expenditure in the 1990s and in the early 2000's have been the main cause of rising and high fiscal deficits – on average over 6 percent of GDP in 1999-2002. Since 2000, the Government has taken steps to repay accumulated arrears, to implement expenditure cuts and to undertake structural reforms that will have a long-term positive impact on fiscal sustainability (defense, pension, health reform, budget management reform).

While the reduction in primary current spending managed to restore positive current savings, higher public investment implied that the primary fiscal deficit was only partially reduced between

**Figure 2.1: General Government Overall Balance (% of GDP)**



Source: IMF, WB database.

1999 and 2002 from over 6 percent of GDP to around 3 percent of GDP. This is in sharp contrast with average primary balance deficits of under 1 percent in 1995-98 and a surplus of over 2 percent of GDP in 1994. Croatia's fiscal performance fares equally badly in comparison with accession and EU countries (Figure 2.1). On average, all three groups of countries managed to break through the Maastricht deficit level of minus 3 percent of GDP.

### **Debt Accumulation**

2.31 The financing of these large deficits has been facilitated by increasingly favorable access to international capital markets with spreads on Croatian eurobonds falling to about 100 basis points over equivalent German bonds by early 2003. Of course, the budget deficits have also been financed by significant privatization receipts. Despite the inflow of privatization receipts, the share of direct government debt to GDP has expanded from 30.3 percent to 42.8 percent of GDP between 1995 and 2002. However, if publicly guaranteed debt and arrears are added to direct government debt, the stock of this broader definition of public debt increased from 30.3 percent to 60.9 percent of GDP in the same period (Table 2.7).<sup>25</sup> On average, accession and EU countries have in the last six years succeeded in reducing their public debt ratios by 3.3 percent of GDP, and 8.3 percent of GDP, respectively. Accession countries' debt level remained on average at 35 percent of GDP, far below the EU average of almost 63 percent and well below the level registered by Croatia in 2001.

2.32 In addition to the financing of budget deficits, public debt has also grown to finance the bailouts and further recapitalization of several banks and public enterprises, or to cover under-funded obligations of the deposit insurance scheme and the health fund deficit. Based on CNB and MoF data, staff estimates indicate that 8 percent of total public debt stemmed from bank rehabilitation and deposit insurance, 6 percent from health system rehabilitation including arrears, 12 percent from shipyards, 7 percent from transport and 1 percent from *agro-kombinats*. Fiscal developments in the last three to four years have also revealed two other important sources of debt accumulation: unpaid internal obligations of the public sector (arrears) and contingent liabilities in the form of state guarantees (Figure 2.2). The Government accumulated significant arrears - 1.5 percent of GDP per year in 1996-99. Government guarantees have increased significantly since 1996, reaching an amount equivalent to 14.5 percent of GDP in outstanding guarantees<sup>26</sup> by end-2001. Such guarantees represent a major source of contingent liabilities for the budget. Before 2003 there was no firm criteria for selecting guarantees' beneficiaries, and guarantees were most often issued without a clear plan or risk containment measures.

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<sup>25</sup> The reference to public debt includes central government domestic and external debt, plus public guarantees (both financial and performance guarantees though excluding intergovernmental guarantees), plus all short-term liabilities of the health sector and other public sector arrears and direct debt of all local government units.

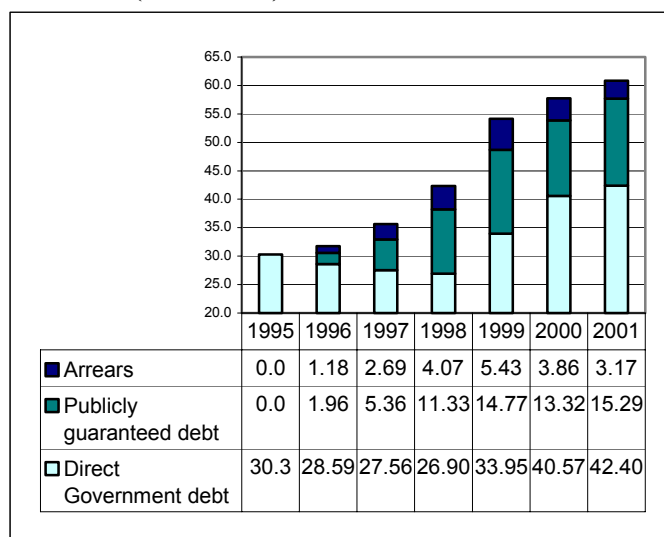
<sup>26</sup> Includes financial and performance guarantees. The outstanding amount is the author's estimate based on official MoF data.

**Table 2.7: Consolidated General Government Debt and Interest Payments (% of GDP)**

	Government debt			Interest payments	
	1995	2001	Difference	1995	2000
Lithuania <sup>1/</sup>	17.8	29.2	+11.4	0.4	1.8
Latvia <sup>1/</sup>	12.0 <sup>3/</sup>	16.8	+4.8	1.2	1.1
Estonia <sup>2/</sup>	8.6	6.3	-2.3	0.2	0.4
Czech Republic <sup>1/</sup>	15.3	41.7	+26.4	1.2	1.1
Poland	54.3	43.4	-10.9	4.5	2.7
Romania	25.5 <sup>3/</sup>	25.8	+0.3	1.4	4.9
Hungary	86.3	52.1	-34.2	9.3	6.2
Bulgaria	120.6	70.0	-50.6	14.6	4.3
Slovenia	23.3 <sup>3/</sup>	24.8	+1.5	1.2	1.5
Slovak Republic	22.8	43.0	+20.2	n.a	2.9
<b>Av. CEEC</b>	<b>38.7</b>	<b>35.3</b>	<b>-3.3</b>	<b>3.8</b>	<b>2.7</b>
<b>Croatia</b>	<b>30.3</b>	<b>42.4</b>	<b>+12.1</b>	<b>1.4</b>	<b>2.2<sup>4</sup></b>
<b>Croatia<sup>2/</sup></b>	<b>30.3</b>	<b>60.9</b>	<b>+30.6</b>	<b>1.4</b>	<b>2.2<sup>4/</sup></b>
EU	70.9 <sup>3/</sup>	62.6	-8.3	5.4	3.8

Notes: 1/ Includes guarantees; 2/ Includes guarantees and arrears; 3/ for 1997 instead; 4/ for 2001.

Source: World Bank, IMF (GFS).

**Figure 2.2: General Government Debt and Contingent Liabilities (% of GDP)**

Source: CNB, MoF, staff estimate.

2.33 Access to external financing is quite favorable in terms of cost and availability: spreads on government eurobonds have plunged from 400 basis points in 1998 to less than 100 basis points in 2003. Nevertheless, due to the rising stock of debt annual interest payments in Croatia's budget have increased whereas they have declined in the

case of comparator groups. Concerns on debt sustainability or contagion from other countries in the region or reversals in the market's assessment of Croatia's prospects for eventual EU membership could reverse the improving trend in the terms of government debt. In such a scenario, interest payments could derail the fiscal adjustment strategy that the Government is currently pursuing through an explosive growth of debt service. Similarly, in the event of a depreciation of the kuna, the debt and debt service to GDP ratios could easily jump to potentially unsustainable levels since the bulk of public debt is in foreign currency or indexed to foreign currency. The use of privatization receipts to finance deficits has so far served to release some budgetary pressures, but it is not a viable long-term strategy as privatization receipts are expected to diminish after 2005.

### Debt Sustainability

2.34 Croatia's fast accumulation of public debt—particularly its broader measure which includes arrears and public guarantees—already raises concerns on inter-temporal solvency. Even if Croatia manages to maintain average real exchange rates and real interest rates of the last five years, the analysis below shows that the current fiscal stance could lead to explosive debt growth.<sup>27</sup>

2.35 The primary fiscal deficit required to maintain a constant level of debt relative to GDP, based on assumptions regarding growth, inflation and the public demand for money is far lower than the current one. Assuming under the base scenario annual inflation at 3 percent and economic growth at 5 percent, **the required primary fiscal deficit for debt sustainability is 0.7 percent of GDP** (Table 2.8). This comes from a combined estimated real debt service cost of 0.24 percent of GDP (this is net of growth's effect on the stock of debt), plus seignorage revenue of 0.91 percent of GDP.<sup>28</sup> Under this scenario, the primary fiscal deficit would have to be reduced by over 2 percent of GDP.

2.36 Alternative scenarios illustrate also how sensitive the required primary balance is to changes in the assumptions about growth, inflation and the real interest rate.<sup>29</sup> For

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<sup>27</sup> This analysis is a replication of the fiscal sustainability analysis described in Annex A of the World Bank (2002a) with 2001 data. Initial public debt level is estimated at 47.5 percent of GDP (adding several percent of GDP to direct Government debt to account for the called guarantees (here a call rate of about 10 percent is assumed) and the repayment of arrears), long-run inflation at 3 percent, long-run real growth rate at 5 percent, world real interest rate at 5.5, base money at 14.7 percent of GDP and interest rate on 91-days' CNB bills at 3.06 (end 2001).

<sup>28</sup> The previous analysis has already shown that money demand is so elastic in Croatia that the *maximal* seignorage the Government could raise is not much higher: seignorage is maximized, by a 20 percent inflation rate, at just 1.7 percent of GDP. This means that even in a high inflation environment the primary fiscal surplus could be no lower than -1.4 percent of GDP.

<sup>29</sup> The initial stock of debt can be a critical factor in calculating the required primary surplus. The calculations done above have used official Central Bank data on the Government's current level of indebtedness and staff estimates of outstanding contingent liabilities and arrears (in the case of the Health Fund all short-term unpaid liabilities for the long payment settlement period that the Health Fund is currently negotiating – 120-180 days). The analysis is also based on the Ministry of Finance data on issued guarantees and arrears. Potential future privatization revenue and central bank reserves were not used in this exercise.

**Table 2.8: Alternative Scenarios for the Short-Run Sustainable Primary Surplus**

	Growth rate of GDP (%)	Real interest rate (%)	Inflation rate (%)	Initial public debt (% of GDP)	Sustainable primary surplus (% of GDP)
Baseline	5	5.5	3	0.475	-0.67
	2				1.1
Growth scenarios	3	5.5	3	0.475	0.5
	4				0.08
		4.5			-1.17
Real interest rate scenarios	5	7.5	3	0.475	0.34
		9.5			1.34
			5.5		-0.86
Inflation rate scenarios	5	5.5	7.5	0.475	-1.0
			9.5		-1.11

*Source:* World Bank staff estimates.

example, if projected growth averages 3 percent, the Government would need to run a primary surplus of about 0.5 percent of GDP. Alternatively, if growth remains at 5 percent but real interest rates rise to 9.5 percent, the required primary fiscal surplus would be over 1.3 percent of GDP. Once the real interest rate exceeds the real growth rate, debt can accumulate very rapidly, and the size of the debt stock becomes important. The high inflation elasticity of money demand suggests that the scope for raising seignorage through higher inflation is at best limited – a common feature of countries where currency substitution is widespread.

2.37 It follows that the fiscal policy stance in the second half of the 1990s was not sustainable; – a fact that is clearly demonstrated by fast debt growth. While since 2000 there has been a significant change in the trend, this change is not yet sufficient to restore inter-temporal solvency. In the long-run, the Government must accumulate *real* debt (as a share of GDP) at a rate lower than the real rate of interest in order to be able to amortize at least some small fraction of its debt.

2.38 More generally, to avoid these kinds of vulnerabilities, *Croatia should consider pursuing a more rapid fiscal adjustment strategy*. For example, it could adopt a structural balance approach as adopted recently by Chile. This would avoid over-spending in the upswing while protecting the economy in the downswing. At a minimum, such fine tuning will require further development of budget management processes as proposed in the public administration reform chapter (see Chapter 4).

## Approaching Sustainability

2.39 A quantitative approach employed to assess fiscal sustainability<sup>30</sup> looks at net government liability flows rather than stocks or deficit levels. It analyzes whether a country is on the right track to regain fiscal sustainability. There are three questions to be answered in this evaluation process:

- Has there been a reduction of primary deficit-to-GDP ratio of at least 0.5 percentage points of GDP?
- Is the relative contribution of the share of spending cuts in the reduction of deficit during the consolidation equal to at least 2/3 of the initial contribution to the fiscal deterioration?<sup>31</sup>
- Have appropriate steps been taken in order to reverse the increase in specific spending items which led to the deficit deterioration? The adjustment should be at least half of the initial contribution to fiscal deterioration.

2.40 Positive answers to all three questions indicate that the country has succeeded in at least reversing the actual source of deficit deterioration.

2.41 The available accrual fiscal data shows that between 1997 and 1999 the primary deficit deteriorated 5 p.p. of GDP. The fiscal adjustment that started in 2000 has reversed the trend and the primary deficit declined in the next three years by 3.8 percent of GDP. Therefore, the first sustainability condition was met. Croatia met the second sustainability condition as well since more than two-thirds of the primary deficit deterioration caused by an increase in the primary expenditure-to-GDP ratio (5.5 percent of GDP) was offset by primary spending cuts (5.8 percent of GDP). However, looking at this condition from the revenue side, Croatia would have under-performed since revenues declined 1.9 percent of GDP in 1999-2002 after rising only 0.5 p.p. in 1997-99.

2.42 Croatia does meet the third sustainability condition as the increase in expenditures (including subsidies and transfers) observed in 1997-99 (2.4 p.p. of GDP) were offset by the half rule set. Table 2.9 provides a decomposition of the sources of the deterioration of the fiscal balance in 1997-99 and the sources of improvement in 1999-2002. With the exception of spending on other goods and services (which is at high levels by international standards), all other items contributed to the fiscal expansion in 1997-99. The subsequent fiscal adjustment in 2000-2002 was spread across all spending items.

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<sup>30</sup> This approach was proposed by Perotti, Strauch, von Hagen (1998) to evaluate the readiness of EMU candidates to join the EMU. It was also elaborated in Kraft and Stucka (2002).

<sup>31</sup> The condition is fulfilled if  $\frac{PE_t - PE_T}{PB_t - PB_T} \geq 2/3 \frac{PE_T - PE_\tau}{PB_T - PB_\tau}$ , where PE represents primary expenditure and PB primary balance, all as percent of GDP, t denotes year 2001, T denotes the first year of fiscal adjustment (or 1999), while  $\tau$  represents the year when fiscal deterioration started.

**Table 2.9: Contributions to Fiscal Deterioration and Adjustment**

	Difference		Contributions (%)		
	As % of GDP		Deterioration	Actual outcome	Required outcome
	(1999-97)	(2002-99)	(1999-97)	(2002-99)	1/2 of 1997 expansion
Consumption	1.3	-3.2	27.1	82.5	13.6
Wages	1.9	-1.8	37.5	47.1	18.7
Purchases	-0.5	-1.4	10.4	35.3	-5.2
Subsidies and transfers	2.4	-1.4	47.9	36.5	23.9
Capital expenditure	1.1	-0.6	23.2	14.8	11.6

Source: MoF and World Bank staff estimates.

2.43 In any case, the *simplified framework outlined above has to be used with caution, particularly because **the direction of change has to be sustained** to ensure that desirable fiscal targets are eventually achieved.* In the case of Croatia, further reductions in spending will be required, particularly of subsidies and transfers. But one also has to take into account that the conclusions are very sensitive to the initial year chosen. While 1997 was a relatively good fiscal year, it exhibits significant distortions as far as the high levels of public expenditure is concerned. More generally, the limitation of this approach is that it doesn't take into account cyclical factors. The capacity to adjust expenditures or revenues is not invariant over the (possible) economic cycle; this implies, for example, that in a downturn transfers may grow/revenues drop (endogenously). In this case, the same criteria could lead to opposite conclusions depending on which phase of the cycle the economy is situated.

2.44 In short, *although there has been a shift in the direction of sustainable fiscal policy since 2000, the path ahead includes significant constraints and/or risks:*

- The Government can only plan to rely heavily on privatization revenue to finance the budget until 2005;
- There is a lack of potential new sources of revenue - tax revenue already represents over 41 percent of GDP;
- There appears to be a lack of commitment to further implement cuts in the public sector wage bill which remains much higher than in other CEECs;
- Slashing maintenance of public infrastructure can be a dangerous tactic in the long-run;
- The Government has not reduced sufficiently State intervention through cuts in subsidies and current transfers, currently the biggest spending item;
- Despite some recent improvements, significant arrears remain; and local government arrears have not yet been addressed;
- The call rate of government guarantees has been increasing (since 1998 a total of HRK2.5 billion or 1.5 percent of GDP has been spent on called guarantees).

2.45 It follows that, even under the most optimistic scenario, the Government will need to undertake a much deeper fiscal adjustment to leave room for new expenditures that would arise from reforms and investments that would need to be carried out if the

Government is to pursue its goal of European integration. To be sustainable, fiscal adjustment will require efficient budget management, an area in which Croatia has already made significant progress in the past decade. There are at least three key areas of budget management which need substantial improvement.<sup>32</sup>

*First*, the Ministry of Finance has limited capacity to develop budget options, push public finance reforms, monitor and control spending, and enforce current laws and regulations. Internal controls and auditing are not well established, and spending units may enter the commitment into the accounting system until well after it is due.

*Second*, budgeting in Croatia lacks performance orientation. A key problem is the lack of integration of strategic priorities into budget allocations, while laws enacted outside of the budget process lead to overspending. The new multi-year fiscal framework became binding after the adoption of the 2002 Budget Law, but is thus far an untested policy tool.

*Third*, contingent liabilities (especially guarantees) and expenditure arrears have not been properly covered; hidden subsidies to public enterprises do not appear in the budget.

2.46 Strengthening of the budgetary process would ensure a more transparent system of public finances and would result in important budgetary savings. This has been recognized by the Government, the issues describe above were partially addressed in the recent legislative changes of the Budget and Budget Execution Laws and adoption of State Aid Law.<sup>33</sup> The amendments: strengthen the enforcement of penalties for overspending budgeted resources; set the guarantee issuance criteria and their annual limit; set an accounting practice to cover all fiscal and quasi-fiscal activities; and improve the monitoring, reporting and implementation of the subsidies' harmonization program.

2.47 The Government's ability to fix its financial situation without a major fiscal reform effort is questionable. A well-designed fiscal reform would improve Croatia's prospects for sustained growth. The next section summarizes Croatia's key fiscal challenges ahead.<sup>34</sup>

#### **D. MEDIUM-TERM FISCAL REFORM AGENDA**

2.48 This section assesses the challenges for public expenditure restructuring and meeting the requirements which would be necessary for European integration, such as enterprise restructuring, education, transport and energy infrastructure and environment, social protection and health. It concludes with a simulation of fiscal scenarios that

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<sup>32</sup> See Chapter 4 for further details on budget management improvements.

<sup>33</sup> The activity required for implementation of Stabilization and Association Agreement with the European Union under Government State Aid (Art. 70), EC (2001a).

<sup>34</sup> The background papers on several key sectors compiled for this Report were used as source (EU/CEM, Background papers, mimeo, 2002). The analysis also draws on the previous work done for the Public Expenditure and Institutional Review (World Bank, 2002a) and a Regional Study on Pre-accession Expenditure Policy (World Bank, 2002b).

incorporate pre-accession and reform costs and benefits for 2003-2008 under different assumptions of the output growth rate.

### **Medium-term Fiscal Impact of European Integration Reforms**

2.49 This Report is strongly focused on reforms and investments which are at once required for growth and European integration. The ultimate design and timing of reforms and investments is difficult to predict, let alone the willingness and financial resources of the Government to implement them. In view of these difficulties, a scenario is elaborated below in which at least some of the more important reforms proposed in this Report are implemented while other government plans, even if not endorsed by this Report, also materialize.

2.50 Table 2.10 summarizes estimated investment costs and gains derived from adopting selected EU standards and policies discussed in this Report. It reports cumulative costs and gains over 2003-2008 expressed as a percentage of 2002 GDP. As is discussed throughout the Report, the costs and benefits of these policies and standards will depend on the modalities of their introduction. For example, in the environmental sector, market-based instruments can lower investment needs by inducing polluters to internalize the cost of the environmental damage that they cause. For illustrative purposes, the simulation below considers a medium-reform scenario. Another big expenditure item consists of investment in highways until 2005 for which the scenario relies on the Government's own (ambitious) projection. Similarly, the simulation computes staff estimates of the large transition costs of pension reform, due to the flow of contributions to the second pillar funds netted out for savings from the first pillar, as an expenditure. On the other hand, the most important "gains" items are: privatization receipts; reductions in road investments after 2005; toll revenue and higher excise taxes from oil derivatives; reduction in public administration staff and freeze on real wages over 2003-04. Other relatively less important, but still sizable, gains are projected to accrue from savings in defense; improved compliance with payroll taxes; reductions in reconstruction activity after 2004; and environmental fees.

2.51 The budgetary impact of this scenario will help put in perspective the additional fiscal adjustment effort that Croatia needs to make to attain debt sustainability. According to the scenario described, total costs would be only marginally higher than total gains with the annualized average net cost (over 2003-08) expected to be around 0.5 percent of 2002 GDP. The implications for overall debt sustainability are examined below under alternative growth scenarios.

### **Budgetary and Debt Impact of Reform Program under Alternative Growth Scenarios**

2.52 Aware of the need to improve public finances, the Government's three-year fiscal program envisages a 2.9 percent of GDP reduction of public expenditures over the 2003-2005 period (of which 2.6 percent of GDP correspond to other than transitions cost expenditures). Under the assumption of average annual growth of 4.5 percent and inflation of around 3 percent, expenditure constraints are expected to lead to a similar

reduction of the primary deficit and the Consolidated General Government deficit (excluding privatization proceeds) which will decline respectively to 1.1 percent of GDP and 3.5 percent of GDP by 2005 (Table 2.11 – accrual basis). *The fiscal adjustments envisaged by the Government fall short of what is needed for debt sustainability* – with 3 percent inflation, 5.5 percent interest rates and growth of 5 percent, the maximum primary deficit for debt sustainability was 0.67 percent of GDP. The required primary deficit for debt sustainability is about one-third of the average primary deficit envisaged for 2003-05 – 1.7 percent of GDP.

2.53 If growth were to falter, say to 3 percent, a primary surplus of 0.5 percent of GDP would be required – that is, 1.2 percent of GDP more than the average planned by the Government (1.7 percent of GDP). Moreover, net fiscal costs of the pre-accession strategy discussed earlier are not incorporated into the analysis.

2.54 The average 2003-2005 and 2006-08 fiscal outcomes of the Government's plans combined with the pre-accession reforms discussed above are summarized in Tables 2.12, the *high growth scenario* which assumes average GDP growth of 4.5 percent, and in Table 2.13, the *low growth scenario* which assumes 2.5 percent average GDP growth.

2.55 In the *high growth scenario*, the average primary fiscal deficit in 2003-05 is 2.8 percent of GDP and it only reaches levels compatible with debt sustainability in 2006-08. Note, however, that public debt declines from 60.6 percent of GDP in 2002 to 56.9 percent of GDP in 2003-2005 because privatization proceeds (on average 1.8 percent of GDP until 2005) are not netted out from the overall deficit – privatization proceeds disappear after 2005. Subsequently, public debt declines further to 52.3 percent of GDP in 2006-08. The overall fiscal deficit declines from 4.8 percent of GDP in 2002 to an average 2.3 percent of GDP in 2006-08, or 1.5 percent after netting out second pillar introduction costs. Fiscal adjustment under this scenario stems primarily from expenditure reductions – revenues decline almost 3 percent of GDP between 2002 and 2006-08. Lower public expenditures are made up of a 0.04 percent of GDP average reduction in 2003-05 and a further reduction of 5.5 percent of GDP over 2006-08. The overall reduction in expenditures is accounted primarily by **reductions** in subsidies and transfers (1.8 percent), purchases of goods and services (1.6 percent), wages and salaries (1.3 percent) and capital transfers (0.8 percent).

2.56 In the low growth scenario, despite fiscal adjustment and reform, the average primary fiscal deficit in 2003-05 is higher than under the high growth scenario - 3.7 percent of GDP compared to 2.8 percent of GDP. This is due primarily to a far smaller reduction in subsidies and current transfers than under the high growth scenario; other purchases of goods and services also experiences a smaller decline. The overall deficit rises even more - to 6.3 percent of GDP in 2003-05 - as higher debt refinancing risk leads to higher interest payments. Under the low growth scenario, privatization proceeds do not suffice to avoid further increases in the debt-GDP ratio over 2003-05. Debt sustainability is restored after more drastic fiscal adjustments are implemented in 2006-08, particularly, cuts in the public investment program of about one-third, and wages and salaries, whose share to GDP declines by 2.3 percentage points compared to 1.3 percentage points in the high growth scenario.

**Table 2.10: Budget Impact of Selected Reforms (Cumulative 2003-2008), as % of 2002 GDP**

	Costs	Gains	Source
<b>1. Trade liberalization</b>			
- Reduced trade taxation	1.4		WB estimate; weighted average custom duties reduced from about 6 percent to 4 percent
<b>2. Environment</b>			
- Quality of water	4.9		WB estimate based on National Strategy Paper; medium reform
- Industrial directives (IPPC) and other	0.2		WB estimate based on National Strategy Paper; medium reform
- Quality of air	0.0		WB estimate based on National Strategy Paper; medium reform
- Waste management	1.9		WB estimate based on National Strategy Paper; medium reform
- Fees for CO2 emission, SO2, hazardous waste		1.4	WB estimate based on Government plan for Environmental Fund revenues
<b>3. Infrastructure and reconstruction</b>			
- Roads	12.9	4.5	Government program for investments into highways and road maintenance by 2005, and a reduction of 1.5 percent of GDP annually after that
- Road tolls, increased excises		5.0	Increased tolls and excises on oil derivatives for building highways and road maintenance by 2005
- Railways restructuring	0.7	0.5	WB estimate; severance packages for staff downsizing and investment in infrastructure; reduced operating costs after a staff reduction by 4,000
- Reconstruction	1	2.8	WB estimate based on the Government plan to finalize the reconstruction in the next two years, and subsequent fall in housing expenditure after 2004
- Land Registry	0.18		WB estimate for initial costs of updating land registry and cadastre in pilot areas (5 yrs)
- EU grants during SAA period		1.6	EC strategy; 60 mill euro per year by the accession year
<b>4. Social sector</b>			
- Education	2.25		WB estimate; realign education spending with the EU average (cost for six years)
- Pension reform	5.91		WB estimate; gross transition cost due to the flow of contributions to the second pillar funds netted out for savings in the first pillar
- Payroll tax compliance effect		2.52	WB estimate; broadening of contribution base, improved recording and collection
<b>5. Public administration</b>			
- Public Admin		4.8	WB estimate; reduction in the number of staff and real freeze on wages in 2003-2004 period
- Defense		2.5	WB estimate; reduction in the number of staff by 13,000
<b>6. Agriculture</b>			
- Agricultural reform	0.94		Government estimate; introduction of the income-support subsidies
- Trade-related budgetary costs	0.36		WB estimate; unilateral adoption of Agenda 2000 prices before accession and export refunds costs
- Revenue from tariffs		0.16	WB estimate; increased revenue from tariffs due to an increase in agricultural imports
<b>7. Privatization</b>			
- Shipyards restructuring	1.65		Government decision to increase subsidies for shipyards (from 7 to 10 percent) and repay their debt
- Privatization receipts		5.40	WB estimate; privatization of public enterprises and remaining CPF portfolio
<b>8. Financial sector</b>			
- Postal Bank restructuring	0.28		Government decision to recapitalize Postal Bank before partial privatization (two years' period)
<b>Total reforms costs/gains</b>	<b>34.57</b>	<b>31.17</b>	
<b>Annual average as percent of GDP</b>	<b>5.76</b>	<b>5.19</b>	

Source: World Bank staff estimates.

**Table 2.11: Government's Medium-Term Fiscal Program, 2001-03**

<b>Percentage of GDP</b>	<b>2002<sup>a</sup></b>	<b>2003<sup>p</sup></b>	<b>2004<sup>p</sup></b>	<b>2005<sup>p</sup></b>
Revenue and Grants	45.1	45.4	45.0	45.0
Expenditure and net lending	51.4	50.4	49.0	48.5
Consolidated General Gov. Balance <sup>b</sup>	-6.3	-5.0	-4.0	-3.5
<i>Primary Balance</i>	-4.0	-2.5	-1.5	-1.1
<u>Memorandum Items</u>				
Inflation ( percent per year)	4.0	3.5	3.0	3.0
Growth ( percent per year)	3.5	4.0	4.5	5.0
Second pillar introduction cost	1.3	1.3	1.1	1.0
Change in other than transition cost expenditures	-2.5	-1.0	-1.2	-0.4

*Notes:*

a/ Accrual, preliminary estimate of the Ministry of Finance.

b/ Excluding privatization revenues.

p/ Based on MoF's three-year framework.

*Source:* MoF and World Bank staff estimates.

**Table 2.12: Croatia – Medium-Term Fiscal Framework: High Growth Scenario**

Consolidated General Government, % of GDP*	Average				Comments
	2001	2002est	2003- 2005	2006- 2008	
<b>TOTAL REVENUE &amp; GRANTS</b>	<b>46.7</b>	<b>46.9</b>	<b>46.9</b>	<b>44.2</b>	
CURRENT REVENUES	46.0	46.2	45.9	43.5	Reflects tariff reduction; increase of fuel excise tax and road tolls; improved compliance and broadened tax base for payroll taxes; reduced personal income taxation through an increase in personal exemption threshold; introduction of modern property tax
CAPITAL REVENUES	0.7	0.7	0.6	0.4	Excludes privatization receipts.
GRANTS	0.0	0.0	0.3	0.3	EU grants annually at 60 mill EUR starting from 2003.
<i>o/w EU grants</i>	<i>0.0</i>	<i>0.0</i>	<i>0.3</i>	<i>0.3</i>	
<b>TOTAL EXPENDITURE AND NET LENDING</b>	<b>53.5</b>	<b>51.7</b>	<b>52.1</b>	<b>46.6</b>	
CURRENT EXPENDITURE	47.3	44.1	43.1	39.7	
<i>o/w Wages and salaries</i>	<i>11.9</i>	<i>11.0</i>	<i>10.1</i>	<i>9.7</i>	Assumes nominal wage bill freeze in 2003 and subsequent real growth of 2-3 percent a year, with a reduction of staff by 13,000 in defense.
<i>o/w Other purchases of goods and services</i>	<i>11.6</i>	<i>11.1</i>	<i>10.6</i>	<i>9.5</i>	Inflation correction by 3 percent and increase of road maintenance costs, education spending and costs of land registry update.
<i>o/w Interest Payments</i>	<i>2.2</i>	<i>2.1</i>	<i>2.5</i>	<i>2.4</i>	Assumes no decline in real interest rates.
<i>o/w Subsidies and current transfers</i>	<i>21.5</i>	<i>19.9</i>	<i>19.9</i>	<i>18.1</i>	Includes costs for Railways, shipyards and Postal Bank restructuring, as well as increase in subsidies for agriculture. Also reflects price/wage indexation of pensions.
CAPITAL EXPENDITURE	5.5	7.1	8.1	6.1	
<i>o/w Investments</i>	<i>3.7</i>	<i>5.1</i>	<i>6.2</i>	<i>4.9</i>	Includes additional investment in roads and highways as well as in water and wastewater systems.
<i>o/w Capital transfers</i>	<i>1.8</i>	<i>2.0</i>	<i>1.9</i>	<i>1.2</i>	Includes costs for final stage of reconstruction and a subsequent fall in spending in years 2005-2008.
LENDING MINUS REPAYMENT	0.7	0.5	0.9	0.8	
<b>OVERALL DEFICIT/SURPLUS</b>	<b>-6.8</b>	<b>-4.8</b>	<b>-5.2</b>	<b>-2.3</b>	
<i>Adjusted for second pillar introduction costs</i>	<i>-6.8</i>	<i>-3.5</i>	<i>-4.1</i>	<i>-1.5</i>	
<i>Privatization receipts</i>	<i>3.4</i>	<i>1.4</i>	<i>1.8</i>	<i>0.0</i>	Assumes privatization of public enterprises and SOEs from Croatian Privatization Fund.
<b>PRIMARY DEFICIT/SURPLUS</b>	<b>-4.5</b>	<b>-2.7</b>	<b>-2.8</b>	<b>0.1</b>	
CURRENT DEFICIT/SURPLUS	-1.3	2.1	2.8	3.8	
<b>PUBLIC DEBT</b>	<b>60.9</b>	<b>60.6</b>	<b>56.9</b>	<b>52.3</b>	

• assumes real GDP growth rate of 4.5 percent per year.

Source: MoF and World Bank staff estimates.

**Table 2.13: Croatia – Medium-Term Fiscal Framework: Low Growth Scenario**

Consolidated General Government, % of GDP*	Average				Comments
	2001	2002 est	2003- 2005	2006- 2008	
<b>TOTAL REVENUE &amp; GRANTS</b>	<b>46.7</b>	<b>46.9</b>	<b>46.5</b>	<b>43.7</b>	
CURRENT REVENUES	46.0	46.2	45.6	42.9	Reflects lower rate of growth, tariff reduction, increase of fuel excise tax and road tolls, reduced personal income taxation through an increase in personal exemption threshold, introduction of modern property tax.
CAPITAL REVENUES	0.7	0.7	0.6	0.5	Excludes privatization receipts.
GRANTS	0.0	0.0	0.3	0.3	EU grants annually at 60 mill EUR starting from 2003.
<i>o/w EU grants</i>	<i>0.0</i>	<i>0.0</i>	<i>0.3</i>	<i>0.3</i>	
<b>TOTAL EXPENDITURE AND NET LENDING</b>	<b>53.5</b>	<b>51.7</b>	<b>52.8</b>	<b>46.6</b>	
CURRENT EXPENDITURE	47.3	44.1	44.1	40.7	Assumes nominal wage bill freeze from 2003, with a reduction of staff by 13,000 in defense, 6,000 in social sector.
<i>o/w Wages and salaries</i>	<i>11.9</i>	<i>11.0</i>	<i>10.1</i>	<i>8.7</i>	Correction for inflation of 3 percent and increase of road maintenance costs, education spending and costs of land registry update.
<i>o/w Other purchases of goods and services</i>	<i>11.6</i>	<i>11.1</i>	<i>11.0</i>	<i>10.5</i>	Assumes increase in interest payments for refinancing risk.
<i>o/w Interest Payments</i>	<i>2.2</i>	<i>2.1</i>	<i>2.6</i>	<i>2.7</i>	Includes costs for Railways, shipyards and Postal Bank restructuring, as well as increase in subsidies for agriculture. Also reflects price/wage indexation of pensions and rationalization of social transfers.
<i>o/w Subsidies and current transfers</i>	<i>21.5</i>	<i>19.9</i>	<i>20.5</i>	<i>18.8</i>	Includes only investments in roads and highways as well as in water and wastewater systems.
CAPITAL EXP.	5.5	7.1	7.8	5.0	Includes costs for final stage of reconstruction and a subsequent fall in spending in years 2005-2008.
<i>o/w Investments</i>	<i>3.7</i>	<i>5.1</i>	<i>5.9</i>	<i>3.7</i>	
<i>o/w Capital transfers</i>	<i>1.8</i>	<i>2.0</i>	<i>1.9</i>	<i>1.3</i>	
LENDING MINUS REPAYMENT	0.7	0.5	0.9	0.9	
<b>OVERALL DEFICIT/SURPLUS</b>	<b>-6.8</b>	<b>-4.8</b>	<b>-6.3</b>	<b>-2.9</b>	
<i>Adjusted for second pillar introduction costs</i>	<i>-6.8</i>	<i>-3.5</i>	<i>-5.2</i>	<i>-2.1</i>	Assumes privatization of public enterprises and SOEs from Croatian Privatization Fund (low scenario - under fiscal pressure to sell).
<i>Privatization receipts</i>	<i>3.4</i>	<i>1.4</i>	<i>1.5</i>	<i>0.0</i>	
<b>Primary Deficit/Surplus</b>	<b>-4.5</b>	<b>-2.7</b>	<b>-3.7</b>	<b>-0.2</b>	
<b>Current Deficit/Surplus</b>	<b>-1.3</b>	<b>2.1</b>	<b>1.5</b>	<b>2.2</b>	
<b>Public Debt</b>	<b>60.3</b>	<b>60.6</b>	<b>64.1</b>	<b>63.0</b>	

\* assumes real GDP growth rate of 2.5 percent per year.

Source: MoF and World Bank staff estimates.

### **3. THE CHALLENGE OF REGIONAL TRADE INTEGRATION**

3.1 Croatia's merchandise export performance has been disappointing. While the breakup of Yugoslavia and the war and peace process that followed may partly account for that, it appears that Croatia's own structural weaknesses have played at least an equally important role. Croatia has an opportunity to join the single most prosperous free-trade economic area in the world. Can it meet the challenge of fierce competition on the EU market? What is the prognosis for trade and FDI under the SAA? And what would it take, particularly on trade and FDI related policies, to ensure that Croatia benefits most from its trade integration process? These are some of the key issues addressed in this chapter.

3.2 While bilateral trade liberalization may not be the most important aspect of the SAA—indeed Croatia already had most-favored nation (MFN) treatment in the EU for most products during the past decade—the related process has given strong impetus to trade liberalization in all SEECs. Croatia has gone a long way in liberalizing its trade having signed already 35 free trade agreements (FTAs) including the SAA.<sup>35</sup> Yet, bilateral trade liberalization alone will not bring about the full benefits that could be obtained from a broader liberalization of trade. In addition, the timing and sequencing of liberalization is an important trade policy issue as well. This is so largely because the SAA envisages asymmetric trade liberalization (with the EU eliminating most tariffs upfront and the SEECs taking up to six years to do so) and other bilateral FTAs contain different phasing-in periods for different groups of products.

3.3 Much of the dynamism exhibited by trade flows will in any case hinge on the performance of FDI and investment. The investment climate and overall business conditions will thus be more important determinants of future trade flows. The greatest impact of the SAAs will be provided by the requirement to align policies, legislation and institutions with those of the EU. The economic success formula of EU accession countries has indeed been the resulting adoption of progressive (market-based) institutions and policies in a consensus-based environment which simultaneously can preserve idiosyncratic features. The CEECs also have benefited from participation in the Pan-European Cumulation of Origin (PCO) system since 1993. This allows participants to export goods (under preferential terms to the EU) which employ inputs with content produced in any other country under the PCO System. Croatia is not a participant in the

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<sup>35</sup> Croatia's membership in CEFTA became effective in March 2003. Nine FTAs with CEFTA members were subsequently replaced by the CEFTA Agreement (see the next footnote).

PCO - participation would require approval by all EU countries, but if it were able to join the PCO System, the country would become a more attractive destination for export-oriented FDI.

3.4 The chapter begins with a description of the network of FTAs shaping the emerging free trade area spanning much of Europe which provides the competitive context for Croatia's economy over coming decades (Section A). It then reviews trade patterns during the 1990s and assesses, in particular, stagnation of industrial exports and the more recent recovery of tourism (Section B). An attempt is made, conditional on reforms and based on comparisons with the CEECs' experience in the 1990s, to capture the potential impact on trade of the SAA and other regional FTAs (Section C). This is followed with a more specific assessment of the likely sectoral orientation of trade focusing on the role of intra-industry trade and factor contents (Section D). A description of the orientation and impact of FDI on trade and growth permits to assess some of the key constraints that hinder FDI in "greenfield" operations and in particular export-oriented FDI. This includes, for example, existing arrangements on the accumulation of rules of origin for preferential trade with the EU (Section E). The chapter concludes with an evaluation of trade and FDI related policy issues and recommendations (Section F).

#### **A. A NETWORK OF FREE TRADE AGREEMENTS - HOW CAN IT BENEFIT CROATIA?**

3.5 The SAA will facilitate the integration of Croatia into the free-trade area which is emerging across much of Europe, resulting in a significant removal of trade and investment barriers between all countries that are gaining the membership or association status. It will help to transform small and closed economies into a wide area where movements of goods, services and investment are free. However, the objective of effective integration will be achieved as much by the removal of trade barriers as by other crucial impacts of the SAA: acceleration of structural reforms, reduction of regulatory and legal uncertainty, strengthening of cooperation and institutional development and consolidation of peace and democracy – all crucial inputs for fast and sustainable growth. The view that the SAA will essentially benefit Croatia by improving EU market access is, at best, incomplete. Market access to the EU has been in place for at least a decade and has been further enhanced, unilaterally, in September 2000 by extending trade preferences to "Western Balkan" countries. Most tariff ceilings for industrial products, as well as quotas for tariff-free imports of agricultural products allocated to Croatia remained unfilled in recent years. Insufficient enterprise restructuring, labor market rigidities, incomplete financial markets and an inadequate legal and judicial framework are far more important constraints to effective integration and export performance.

3.6 However, closer relations with the EU under the SAA include many other trade and FDI provisions which could foster integration through increased foreign trade (not necessarily with the EU) and FDI. The SAA aims at the creation of a free trade area between the SEECs and the EU on a bilateral basis. The implementation is asymmetric in the sense that the EU liberalizes faster access to its market and for a broader range of products than Croatia. The SAA envisages a period of 6 years to achieve full trade liberalization. Successful implementation of the SAA also emphasizes regional cooperation to reach bilateral agreements between the SEECs that signed SAAs. Croatia

has already signed a number of FTAs with 35 trade partners, including among the SEECs.

3.7 A “Memorandum of Understanding (MOU) on Trade Liberalization and Facilitation” was signed in June 2001, between Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and Yugoslavia. According to the Memorandum, free trade between the signatory countries should be realized by completing the network of FTAs between them by the end of 2002. The agreements, both existing and to be negotiated, would provide for free trade in at least 90 percent of the parties' mutual trade in a transition period of at most six years. Croatia also applied for full CEFTA<sup>36</sup> membership in June 2001 and became a full member in March 2003.

3.8 In addition to liberalized trade in goods with relatively short transition periods, the FTAs cover also other areas of preferential trade agreements, such as the horizontal provisions concerning state monopolies, rules of competition concerning undertakings, state aid, public procurement, dumping, SPS measures, protection of intellectual property rights on a non-discriminatory basis. General and specific safeguards (structural adjustment, balance of payments difficulties and serious shortages) are also included in the agreements, as well as procedures of the Joint Committees. General and specific safeguards are incorporated and there were no additional tariffs introduced on third countries. All concluded agreements are in accordance with Article XXIV of GATT 1994 and Article XXIV of WTO.

3.9 The SAAs do not provide, however, for the diagonal accumulation (or cumulation) of rules of origin. This discourages firms from SEECs (that have signed SAAs) from developing mutual production links oriented towards supplying EU markets, because inputs from these countries are treated as external imports,<sup>37</sup> which thus disqualifies exports from preferential access to the EU. If Croatia and the other SEECs signing SAAs were to join the Pan-European Cumulation of Origin (PCO) system, whereby Croatia could export to the EU (under preferential terms) goods which employ inputs with local content or content produced in any other country under the PCO System (Box 3.1), substantial (additional) FDI and exports could be mobilized.

3.10 FTAs with countries of Central and South-East Europe could remove significant constraints to intra-regional trade. In the situation where CEFTA countries have used preferential trade agreements for their mutual trade as well as for trade with the EU, Croatia and the other SEECs did not benefit from increased trade flows. By joining CEFTA, in the course of 2002, formal barriers to trade will be eliminated. Nevertheless, the constraints to trade within SEECs are still significant for many reasons aside tariffs, including customs procedures and still limited consumer preferences for products originating from the parties involved in the recent war hostilities.

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<sup>36</sup> CEFTA is the Central European Free Trade Agreement including the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia.

<sup>37</sup> B. Kaminski and M. de la Rocha in “Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Association and Stabilization Process”, Regional Report, World Bank, 2002.

3.11 As was pointed out by several authors,<sup>38</sup> despite Croatia's recent successes at trade liberalization, there is still some scope for further liberalization of trade. The following trade policy options should be considered. First, by lowering MFN tariff rates to all countries without FTAs with Croatia, competition in domestic markets would be strengthened and the country would become more attractive for FDI. MFN tariffs could be reduced for example to the level of the EU. Second, Croatia could benefit by speeding up the reduction of its own tariffs applied to EU goods - thus reversing the asymmetric nature of the SAA - with the associated welfare gains derived from lower prices.

**Box 3.1: Pan-European Cumulation of Origin (PCO) System – Impact on Exports and FDI**

Modern industrial processes are becoming increasingly dependent on inter-enterprise relations in order to produce and sell sophisticated products on market. All FTAs envisage that preferentially traded products must have sufficient local content of raw materials, components and added value transformations to be recognized as originating product, qualifying for preferential trade. If a cumulation status exists, source components originating from other member countries will have the same treatment as domestic components. There are three main types of cumulation of origin:

- (1.) Bilateral cumulation: two partners agree to recognize materials sourced in each others territory as originating;
- (2.) Diagonal cumulation: several countries agree to recognize materials sourced in each others territory as originating;
- (3.) Full cumulation: several countries agree to recognize both materials sourced and processing added value arising in each others territory as originating.

The European Council in Copenhagen launched in 1993 an initiative with respect to cumulation of origin, resulting in establishment of Pan-European Cumulation of Origin (PCO) System. This system includes 28 countries (EU, EFTA, CEFTA, the Baltic countries and Turkey). Croatia is still not included in the system, which causes two main types of obstacles:

- It discourages exporters from countries associated in the PCO System from sourcing their inputs from Croatia, because Croatian input does not qualify as local content of a product;
- Croatian exporters are prevented from using the inputs from other countries in bilateral preferential trade. For instance, if a Croatian producer sells a textile product to Germany, inputs from Slovenia cannot be recognized as a local content of product. Due to bilateral cumulation rules, only inputs sourced from the EU will be recognized as a local content of Croatian product, despite the fact that Croatia has FTAs with Slovenia and the EU (including bilateral agreements on rules of origin).

According to estimates of the Croatian Minister of European Integration, the lack of the PCO scheme for Croatia implies that only 30 percent of Croatian exports to the EU can take advantage of preferential (duty free) trade under the SAA. There is a clause in the SAA whereby “the Community declares its readiness to examine, within the Stabilization and Association Council, the issue of Croatia's participation in diagonal cumulation of rules of origin once economic and commercial as well as other relevant conditions for granting diagonal cumulation have been established”.

<sup>38</sup> See B. Kaminski and M. de la Rocha and D. Gressani and C. Michalopoulos in “Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Association and Stabilization Process”, Regional Report, World Bank, 2002.

3.12 Third, while the MOU agreed by SEECs established general principles guiding trade liberalization and regional cooperation, possible inconsistencies between the different FTAs may in fact hamper rather than foster trade. This would be the case if each SAA were adjusted to the specific protective preferences of each SEEC. FTAs between SEECs, although guided by the same general principles, also contain different depths of tariff cuts, asymmetric treatments, product coverage and exceptions. Moving towards multilateral trade liberalization, for example, a new FTA that consolidates previous FTAs between SEECs or pushing the liberalization agenda through WTO, could help to avoid the emerging difficulties resulting from a multiplicity of trade tariffs (at least during the transition) and trade asymmetries which vary by country.

## B. TRADE PATTERNS

3.13 With the share of trade in goods and services in GDP at over 100 percent, Croatia's trade developments are of great significance for its own economy as well as for the patterns of regional integration. Developments in foreign trade can be traced back to 1992, which was the first year when trade with other former Yugoslav republics was included in the foreign trade statistics. (Any comparison with the data on previous years would be misleading because trade within Yugoslavia was the important part of overall trade in most of the sectors.) Total exports of goods and services has been growing steadily over the 1993-2001 period representing 46 percent of GDP in 2001. However, growth can be ascribed almost exclusively to tourism revenues; service exports more than doubled during the period (Table 3.1). Croatia traditionally had a significant surplus in trade in services, the major part of which is tourism, with US\$3.3 billion exports in 2001, a feature that differentiates Croatia from most other transition countries. Merchandise exports instead have stagnated, resulting in a significantly lower share in world trade; the share of Croatia in EU12's imports declined from 0.34 percent in 1993 to 0.19 percent in 2000 whereas the share of CEECs almost doubled.

3.14 Import performance has been far more volatile; after doubling over 1993-97—leading to an unsustainable current account deficit in 1997—they declined modestly and stabilized at around US\$8.5 billion thereafter. The significant increase of services exports in recent years (surpassing the exports in goods in 2001) brought the current account deficit closer to a sustainable level of around 3 percent of GDP.

**Table 3.1: Croatian Foreign Trade 1993 – 2001 (US\$ million)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Goods – exports	3910	4.260	4.633	4.546	4.210	4.604	4.395	4.567	4.752
Goods – imports	4658	5.402	7.892	8.169	9.406	8.752	7.693	7.771	8.764
Goods – balance	-1917	-1.142	-3.259	-3.623	-5.196	-4.147	-3.299	-3.204	-4.012
Goods/services – exports		7.117	7.084	7.843	8.215	8.568	8.118	8.663	9.599
Goods/services – imports		6.625	9.302	9.886	11.387	10.641	9.791	9.599	10.659
Goods/services – balance		492	-2.215	-2.043	-3.172	-2.073	-1.673	-936	-1.060
Current acct balance -%		5.9	-7.7	-5.5	-11.6	-7.1	-6.9	-2.3	-3.1
GDP		5.7							

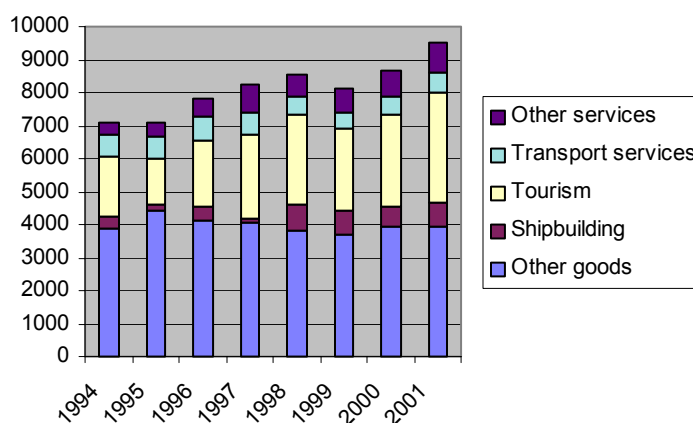
Source: Central Bureau of Statistics, Croatian National Bank.

3.15 The structure of exports by SITC categories shows that machinery and transport equipment had the highest share of Croatia's exports (29 percent of total exports, mainly the shipbuilding industry). Miscellaneous products follow, with 20.7 percent of the total, while products classified by materials have a 14.2 percent share, chemical products 10.6 percent, and fuel and lubricants 10.2 percent of total. The *main change in the composition of exports in the period is the recovery of shipbuilding industry exports from 1998 onwards* which increased the share of machinery and transport equipment in total exports from 20 percent to 30 percent. This was at the expense of a lower share in total exports of miscellaneous manufactured articles (clothing, footwear and furniture) and chemical products. Based on the more detailed NCEA classification, apart from shipbuilding, only *tobacco, telecom equipment and pharmaceuticals*<sup>39</sup> were product groups that significantly gained export competitiveness.

3.16 On the imports side, machinery and transport equipment made up most of Croatia's imports in 2001 (33 percent of total), followed by products classified by material (19.7 percent), fuel and lubricants (13 percent), chemical products (11.5 percent) and miscellaneous goods (11.5 percent). Similar developments (to the ones in exports) were observed on imports: a rising share of machinery and transport equipment, explained by domestic sales of cars and of airplanes for the newly founded national airlines; and a reduced share of imports of miscellaneous manufactured articles.

3.17 What is symptomatic of trade performance is that the overall growth of Croatian exports was driven largely by a post-war recovery in traditional activities like tourism and shipbuilding (Figure 3.1). Tourism increased its share in total exports from 19 percent in 1995 to 35 percent in 2001. If shipbuilding is excluded, exports of goods were stagnant.

**Figure 3.1: Croatian Exports 1994-2001 – Main Sectors (US\$ million)**

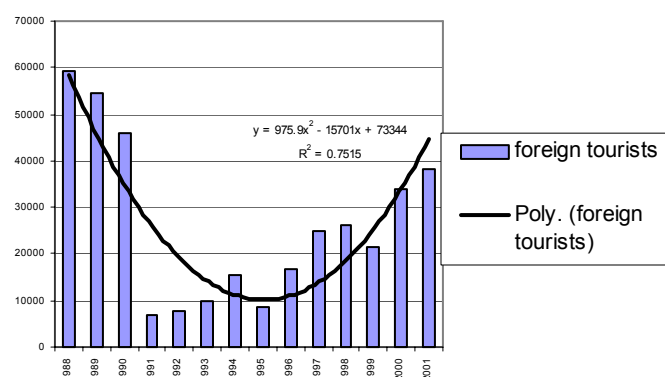


Source: Central Bureau of Statistics.

<sup>39</sup> Pharmaceuticals performance is not evident from CNEA data because it is included in the chemical industry which lost its share in total exports throughout the period.

3.18 The two sectors that mostly contributed to the increase of overall Croatian exports in the recent years—*tourism and shipbuilding*—have been highly volatile in response to *political and security risks in the region*. As Figure 3.2 shows, the rise in tourism during the last decade can be explained largely by the “U” shaped recovery curve from the extremely depressed turnover during the war period from some 50 million overnight stays in the late 1980s to a mere 7-8 million in 1991. Notwithstanding the importance of the recent growth in the sector, the 2001 figure is still only at two-thirds the level of 15 years ago. Along similar lines, the temporary halt in the recovery of tourism in 1999 can be explained by the Kosovo crisis, confirming the economic interests of Croatia to facilitate security and stability in South-East Europe.

**Figure 3.2: Number Of Overnight Stays of Foreign Tourists 1998-2001**



Source: Central Bureau of Statistics.

3.19 A similar story can be told for shipbuilding, in which the production fell from GT 500 in 1990 to below GT 200 in 1995. The significant increase over recent years has brought the industry back to close to pre-war levels (with some restructuring in the production structure from tankers to freight ships). However, the world turnover in the sector increased significantly in the last 15 years, so the share in total world production in 2001 was less than one half of the pre-war share. In short, recent growth of Croatian exports is not based on significant new investments and new markets, but rather on the use of existing facilities to recapture lost markets.

3.20 The EU represents a share of some 55 percent of both exports and imports (Table 3.2). The share of Croatian exports destined to EU countries has diminished somewhat at the end of the 1990s, to recover again in the last three years. The share of EU in total Croatian imports from EU countries decreased somewhat in recent years, remaining, however, above the share in exports. CEFTA countries are also important, making for some 14 percent of total exports in 2001, of which the major part were sold to Slovenia. The share of imports from CEFTA countries remained higher than its share in exports, by some 3-percentage points (15-16 percent). The most noticeable change is a significant decline of the share of exports to CEFTA countries explained by the more than halving of

exports to Slovenia during the period.<sup>40</sup> The share of exports to other European countries (mainly Bosnia and Herzegovina<sup>41</sup>), after a significant increase in 1997, seems to have stabilized at the 20 percent level in recent years.

**Table 3.2: Croatian Foreign Trade 1992-2001, Main Trading Partners (US\$ million)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
<b>EXPORTS 000 USD</b>										
Total	4.426.705	3.910.319	4.402.814	4.517.252	4.643.485	3.981.328	4.517.190	4.302.498	4.431.309	4.659.285
EU	2.389.709	2.251.659	2.599.347	2.608.960	2.336.771	1.999.131	2.154.782	2.110.220	2.415.650	2.547.109
EFTA	60.662	44.808	65.729	59.773	39.834	48.531	79.905	148.467	44.313	49.369
CEFTA	1.137.794	838.022	741.329	800.636	815.776	658.262	598.476	581.683	612.535	565.682
<u>OTHER FT</u>	315.568	278.060	432.137	457.785	666.416	721.891	743.807	655.246	709.376	778.355
ROW	522.972	497.770	564.272	590.098	784.688	553.513	940.220	806.882	649.435	718.770
<b>IMPORTS (000 USD)</b>										
Total	4.421.783	4.658.361	5.529.890	7.351.510	7.783.828	9.101.493	8.275.579	7.798.640	7.886.038	9.043.679
EU	2.106.013	2.637.040	3.301.369	4.547.856	4.622.315	5.419.761	4.906.803	4.414.663	4.367.867	5.060.711
EFTA	76.620	86.243	133.006	200.147	179.662	243.807	229.086	200.792	186.293	193.303
CEFTA	1.239.042	945.114	877.322	1.245.950	1.345.504	1.364.710	1.260.382	1.079.727	1.170.912	1.420.220
OTHER	162.277	57.858	52.039	74.242	126.085	224.766	252.003	222.078	190.327	271.301
FTA										
ROW	837.831	932.106	1.166.154	1.283.315	1.510.262	1.848.449	1.627.305	1.881.380	1.970.639	2.098.144

Source: Central Bureau of Statistics.

3.21 The export product structure cannot be easily linked with the destination of exports. However, some patterns can be identified. For example, exports to the EU are still mainly “traditional”, i.e., composed of textiles, clothing, footwear, wood, paper and furniture. In the exports to Bosnia and Herzegovina and Slovenia, the leading product groups are minerals, fuels and food products. It is interesting to note that exports to Russia are largely composed of pharmaceutical products and telecom equipment. Ships are mostly sold to the rest of the world, while the buyers are generally registered at “flag of convenience” countries like Panama and Liberia.

### **Digression. Is The Trade Surplus in Services a Factor of Merchandise Export’s Stagnation?**

3.22 The large and growing surplus in services could be considered—through its effect on equilibrium exchange rates—an explanatory factor of overall stagnant merchandise exports. Some evidence in support of this hypothesis is provided by the negative

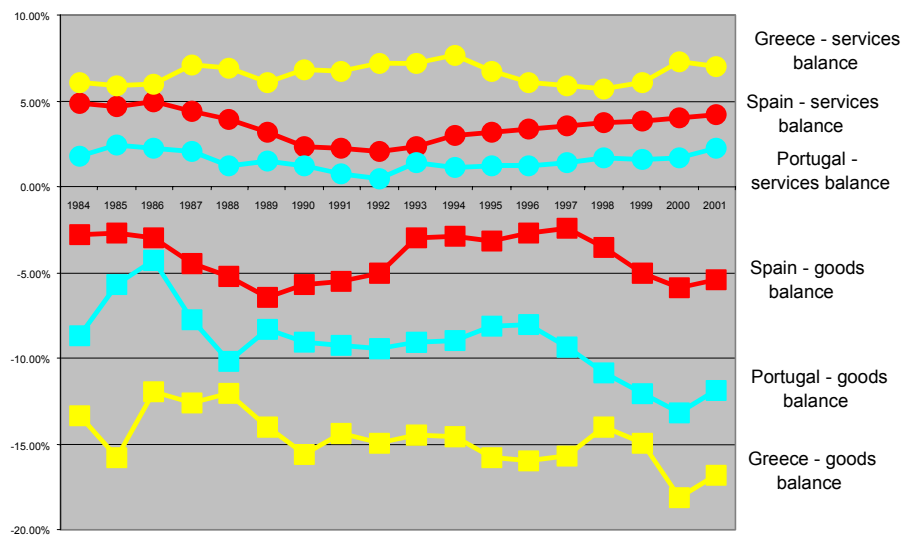
<sup>40</sup> The downward trend in trade with Slovenia is surprising, keeping in mind that Slovenia has concluded a large number of FTAs, which eliminated a large part of demand for imports from Croatia. A very high share (20 percent) in total trade, recorded in the early 1990s, was “inherited” due to high intensity of trade between the two countries while belonging to the former Yugoslavia. After signing the FTA between the two countries, trade has stabilized somewhat below 10 percent of total.

<sup>41</sup> After reaching a maximum of above 15 percent in 1997, the share of Bosnia and Herzegovina in total Croatian exports has fallen to some 12 percent, while exports to Serbia and Montenegro just recently started to increase to reach a noticeable 3 percent level in 2001.

relationship between the good's balance and the service's balance in countries with a large tourist sector, i.e., Greece, Spain, Portugal and Croatia (Figure 3.3).

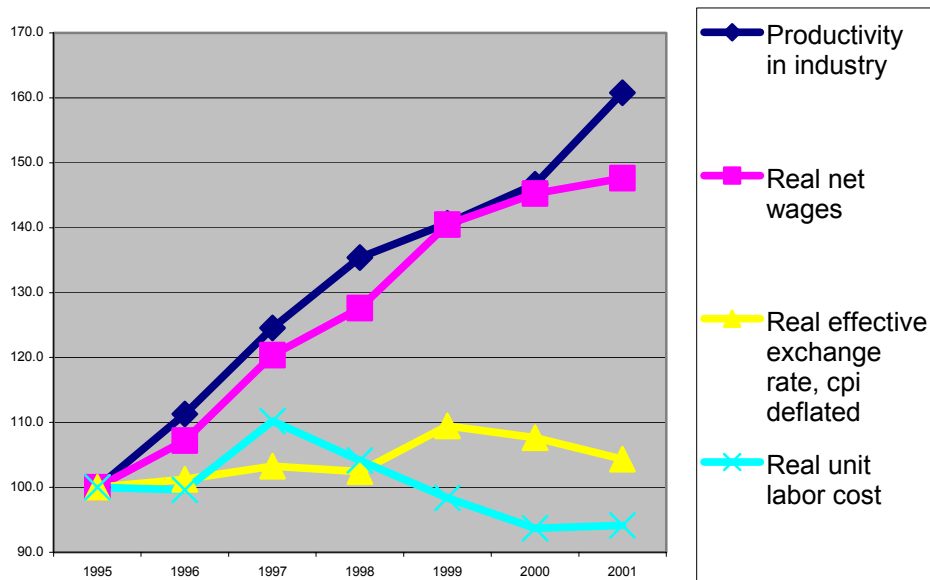
3.23 However, there is no evidence on the causal link through which service surpluses may have led to export stagnation – an exchange rate appreciation. In fact, there has been a slight real depreciation of the kuna. Export competitiveness can be better measured by unit labor costs (ULC). Figure 3.4 shows that although wages grew strongly, labor productivity grew even more strongly (60 percent in the last six years) which resulted in lower ULC (about 5 percent). According to an IMF (2002) report, in the period between June 1995 and April 2002, the partial ULC-based real effective exchange rate of Croatia, based on the consumer-price index and the producer's price index, depreciated by 22.3 percent and 12.6 percent respectively. It thus appears that the dynamics of the exchange rate was not a major factor behind export's stagnation.

**Figure 3.3: Trade Balances - Goods and Services (% of GDP)**



*Source:* Eurostat.

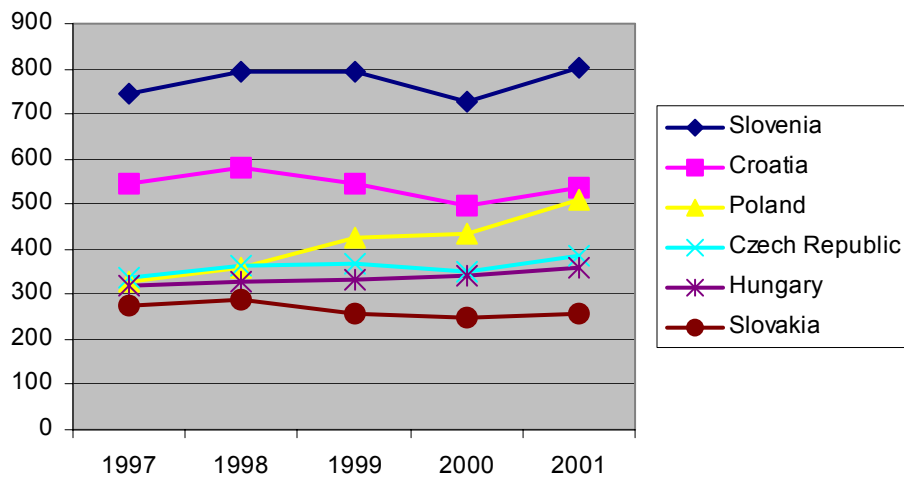
**Figure 3.4: Croatia: Wages, Productivity, Exchange Rate and Unit Labor Costs, 1995-2001**



Source: CNB and World Bank staff estimates.

3.24 It is possible that the exchange rate level, rather than its dynamics, have been detrimental to the competitiveness of Croatian exports. Unlike most SEECs, Croatia is a high wage country and dollar wages in Croatia are also higher than in most CEECs, with the exception of Slovenia; although the gap has narrowed over recent years (Figure 3.5).

**Figure 3.5: Average USD Wages in Croatia and Selected CEECs**



Source: IMF (2002).

3.25 The possibility that the surpluses generated by tourism may have contributed to maintain high dollar wages cannot be ignored; a counterfactual with no service surpluses would probably have led to a more depreciated exchange rate/lower dollar wage levels.

However, an unfinished integration agenda, limited enterprise restructuring and low investment have probably played at least an important role in explaining merchandise export's performance.

### C. IMPACT OF TRADE LIBERALIZATION ON CROATIA'S FOREIGN TRADE

3.26 Assessing the effects of the SAA and regional FTAs agreed by Croatia in isolation from integration processes that are taking place at the regional level may lead to seriously underestimating ongoing and future trade developments in Croatia. The overall framework of regional integration encompasses the following processes which affect Croatia's trade:

- Croatia and other SEECS have joined WTO<sup>42</sup> and there is a framework of lowering the MFN tariffs on imports from the rest of the world, which shall diminish trade diversion towards third countries.
- All other countries of South-East Europe should conclude SAA with the EU, creating also opportunities to increase their trade and investment flows with the EU.
- Croatia and the other SEE countries are in the process of concluding FTAs with each other which shall create favorable conditions for bilateral trade and stimulate regional investment.
- Croatia, as well as the other SEECS have or will have concluded FTAs with a number of other countries, including EFTA and CEFTA countries, meaning that instead of turning into an exclusive trading block, the region is joining a free trade area emerging across much of Europe.
- The EU has accepted new members among the CEECs, which shall further stimulate trade and investment flows between them, partly at the cost of the SEECS entering the lower integration level.<sup>43</sup>
- The EU itself is lowering its MFN tariffs, and negotiating on FTAs with a number of countries, including Mediterranean countries, which would mean that SEECS shall have no significant trade preferences in the EU markets compared to those other countries.

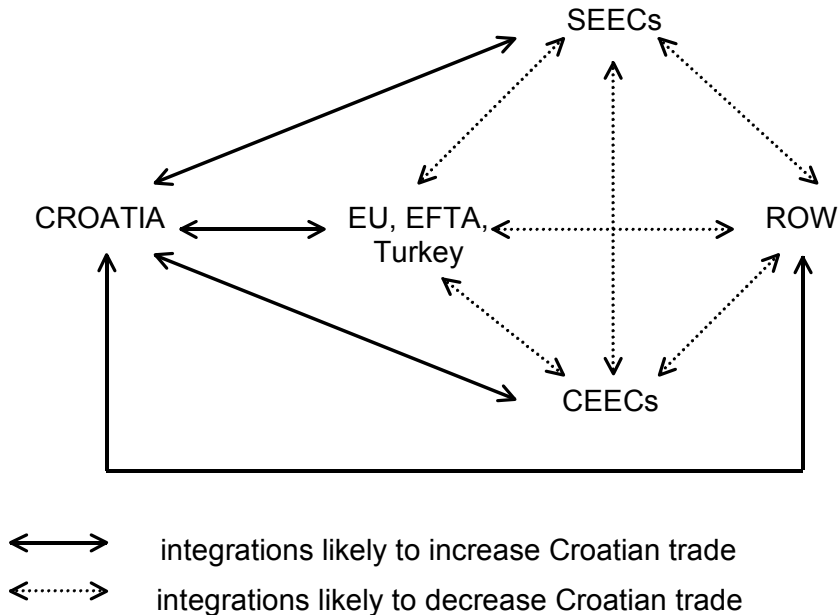
Figure 3.6 presents schematically the above processes indicating whether they are expected to stimulate or reduce Croatian trade:

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<sup>42</sup> Within a WTO trade accord, Croatian tariffs on industrial products should be reduced from 9.7 percent to 5.34 percent in the five-year period ending on January 1, 2005, while the customs duties on agricultural products are to be lowered from 33.7 percent to 15.5 percent until 2007. While most of the tariff reduction was scheduled for the first year of application of the WTO accord, Customs Tariff Schedule for 2001 has brought average tariffs (weighted by 1999 imports) to 6.13 percent.

<sup>43</sup> While full EU membership implies economic and (typically later) monetary union, association status is somewhat deeper than a simple free-trade area. Generally, the deeper is an integration, the greater are the opportunities for trade and investment flows within that integration.

**Figure 3.6: Mid-Term Integration Processes**



*Source:* World Bank staff.

3.27 Since the SAA is not an exclusive arrangement for Croatia, it would be wrong to analyze the effects of the SAA or of FTAs agreed with other countries in isolation from the other simultaneous integration processes. In view of such complexities and the uncertainty of response to increased competition through trade-oriented FDI, the accuracy of any prediction of future Croatian trade flows is necessarily limited; the analysis that follows should thus be regarded mainly as indications of direction and rough estimates of a magnitude of the expected developments.

3.28 Simulations and projections presented hereafter are based on the effects of foreign trade liberalization, referred in the literature as static (short-run) and dynamic (long-run) effects and captured either by estimated elasticities or, indirectly, through comparisons with CEECs' performance (Box 3.2).

### Box 3.2 Short-Run and Long-Run Effects of Trade Integration – A Conceptual Framework

**Short-Run (Static) effects.** These include trade creation (increase of trade within the free-trade area), and trade diversion (reallocating of cheaper imports from the rest of the world to preferential intra-regional imports). Static effects capture the substitution effect from lower prices of imported goods. Consumers benefit from lower prices, exporters earn more due to improved market access while previously protected producers selling in domestic markets partly lose because of the competitive imports. Due to the assumption that supply is perfectly elastic, in the most simplified models new investment is not specified. These models are mostly used for estimating the effects of lowering the tariffs for specific goods in a *partial equilibrium* framework. The cornerstones of the static models are the import demand elasticities and the elasticities of substitution between imports from different countries.

**Long-run (Dynamic) effects.** The evidence indicates that following first-run effects of tariff reductions, foreign trade continues growing, as a consequence of increased competition, scale economies and the improvement of regional competitiveness. Thus, medium- and long-term effects of trade liberalization have to be considered as well. Dynamic effects encompass new opportunities for deep economic relations, inducing a significant response on the supply side, including investment in new production facilities, technological spillovers and increased allocation efficiency. Increased competition from imports implies that most markets become "contestable", and aside from reduced monopolistic powers, this leads to greater impetus for eliminating "X-inefficiencies" (excessive employment, stocks, invisible costs). Trade is bound to increase in sectors characterized by high returns to scale and imperfect competition (Krugman 1994). There are also provisions in the SAA that may also significantly increase trade, in particular, limits on state aid and the elimination of the national preference clause in public procurement.

As many studies of economics of integration have shown, the dynamic effects largely surpass the static ones. For example, predictions of potential export growth of the CEECs in early studies<sup>44</sup> largely underestimated the magnitude of trade developments in recent years. The dismantling of barriers to trade and new investments lead to increased co-operation between the enterprises, bringing trade between the members of FTAs well above the "normal" non-preferential level of trade. This is the case with the so called "**intra-industry trade**", which may be either *vertical* or *horizontal*. Vertical intra-industry trade is the exchange of goods with different quality, while horizontal intra industry trade is trade in products with different characteristics.

### Estimating Short and Long-run Effects of the SAA and Regional FTAs

3.29 For the calculation of short-run effects of the SAA and FTAs a simple model, created by Cline, et al., (1978) was used. The model allows to estimate the short-run

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<sup>44</sup> For Hungary, the most optimistic scenario envisaged doubling of exports to the EU in 2001, compared to 1992, while actual exports surpassed the 1992 value by 2.5 times already in 1998. The same stands also for Poland whereby in a project (Kawecka et al. 1994), liberalization effects were assessed at mere ECU 42 million, which is negligible compared to healthy growth of Polish exports to the EU.

effects of the elimination of tariffs on trade flows.<sup>45</sup> Since no import tariff was applied by the EU for Croatian industrial exports before the SAA, the latter should have no effect on Croatian exports to the EU over the short-run. However, there are positive effects on exports from the removal of existing tariffs for Croatian exports to the CEECs and SEECs (due to the FTAs). The *short-run increase of total Croatian exports to the EU and other partners was estimated to be in the 2.2 percent to 3.7 percent range. Similarly, the increase of imports to Croatia (as a result of the elimination of import tariffs) was estimated to rise between 5.7 percent and 9.4 percent* (see Jurlin-Galinec, 2002). The faster increase in imports is explained by the fact that initially Croatia had higher import tariffs than the EU. In addition, exports typically respond with lags as it requires new investments. Trade diversion (i.e., reduced trade with third countries with which Croatia has not signed FTAs) was estimated to be fairly small – about 0.34 percent of Croatian imports.<sup>46</sup>

3.30 Partial equilibrium models do not capture the long-run effects of trade. In order to capture such effects of trade integration, CGE (computerized general equilibrium) models or gravity-type models can be used.<sup>47</sup> Gravity-type models were used to analyze the impact of the Europe Agreements on advanced CEECs' trade flows. The effects captured are related both to the dismantling of trade barriers (not just tariffs) and the impact of new FDI and investment in general on trade flows.

3.31 Kaminski (2000), for example, pointed out that the share of the EU in total trade of the former “Luxembourg Group” (Czech Republic, Estonia, Hungary, Poland and Slovenia) has even surpassed the shares for several EU members. The most comprehensive study (Fidrmuc, 2000) concluded that trade between CEECs and the EU increased from 40 percent below its *normal* level in 1990, to 30 percent above the *normal* trade level in 1998. Christie (2000) has performed a comprehensive gravity-type analysis of trade potential for the countries of South-East Europe, based on data on CEECs' trade with the EU. According to this study, trade should increase by 90 percent.

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<sup>45</sup> All other effects, including non-tariff barriers to trade, technical standards, rules of origin, together with trade in services, are referred to as long-run effects.

<sup>46</sup> In this calculation, it was assumed that FTAs, including those being negotiated, cover some 75 percent of total Croatian imports, and that, in the short-run (static) context, trade is diverted only towards the rest of the world.

<sup>47</sup> In a gravity approach, bilateral trade is predicted as a function of parameter estimates developed based on historic data of trade of a reference countries. Generally, gravity models include:

- income or output of the exporting countries, as proxy for export supply;
- income or output of the importing country as a proxy for import demand;
- geographical distance, usually measured as distance between the capitals of the two countries, as a proxy for the costs of foreign trade.

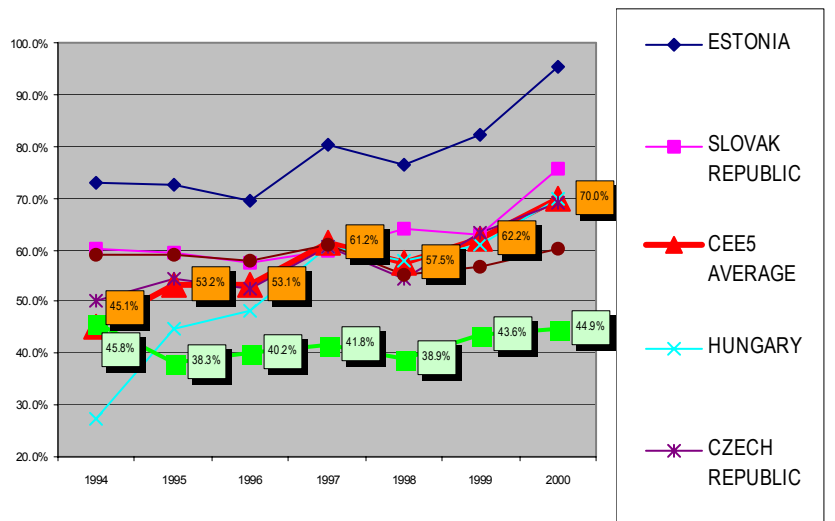
Using regression on historical data, the gravity model is estimated in the following form (all variables in logs):

$T = \beta_1 + \beta_2 Y_M + \beta_3 Y_X + \beta_4 d + \sum \gamma_i D_i + \varepsilon$ , where T is bilateral trade, Y is GDP of importing (M) and exporting (X) countries, d is geographical distance and  $\varepsilon$  is a random disturbance. If described only with these variables, bilateral trade is referred as *normal or potential* trade. Other variables, such as common language, common border, historical or present belonging to a trade block etc., may be included as “*dummies*” ( $D_i$ ) that identify the non-standard nature of trade relations between pairs of countries, with positive coefficients for trade that is above “*normal*” and negative coefficients for trade below “*normal*”.

3.32 Based on a simple extrapolation of the results in the cited studies, it is possible, that in a dynamic/long-run setup, *the SAAs could increase trade between the SEECs and the EU between 30 percent and 90 percent*; this implicitly assumes that SEECs follow a similar reform and integration path than the one implemented by CEECs. However, several factors will tend to moderate such potential impact. For example, as CEECs join the EU—or indeed as the EU signs FTAs with countries from outside the region—trade diversion from SEECs may increase. (Whereas CEECs exports to the EU have increased by 149 percent, exports to other countries rose 31 percent in 1993-99. Therefore, it appears that there was a certain trade diversion towards third countries).

3.33 Consistent with the above prognosis, the CEE5 average share of total exports of goods and services in GDP increased from 45 percent in 1994 to 70 percent in 2000 (Figure 3.7). The share of Croatian exports in GDP instead did not surpass the initial level, which was similar to the initial level of the countries under review. Based on a simple extrapolation of CEE5's experience and assuming implicitly a similar reform, the *SAA and bilateral FTAs could result in an increase of Croatian share of exports of goods and services in GDP of 24 percentage points of GDP over a period of 5-7 years*. Note that the transition period under the SAAs lasts six years compared with the 10 years envisaged by the EAs affecting the CEE5 group.

**Figure 3.7: Developments in Total Exports of the Selected Countries, 1994-2000 (% of GDP)**



Source: IFS, IMF, May 2002.

3.34 From the above analysis it follows that Croatia and the other SEECs are likely to increase their export orientation towards the EU. However, as part of former Yugoslavia it is possible that trade between SEECs will be diverted less than in the case of the CEECs, particularly, as the peace and democratization process consolidates and new regional FTAs are implemented. So far, however, Croatian trade with Slovenia, FYR Macedonia and Bosnia and Herzegovina, in spite of trade liberalization, has virtually stagnated throughout the last three years, at a level significantly lower than the pre-war level.

3.35 Is inter-SEE trade bound to rise? Using a simple gravity model Kaminski and de la Rocha (2002) found that “normal” trade between four SEECs (Croatia, B&H, FYR and S&M) should be US\$1.9 billion; this is only marginally higher than recorded trade of US\$1.6 billion. While the share of trade between these countries is unlikely to rise to the levels reached when they were part of Yugoslavia, it is likely that the potential for growth is larger than the one predicted by the above model. To assess long-run effects, it may be needed to consider explanatory factors such as the existence of a common border, language similarity or compatibility of the production structure due to a common historical heritage.

#### **D. SECTORAL ORIENTATION OF TRADE, INTRA-INDUSTRY TRADE AND FACTOR CONTENTS OF TRADE**

3.36 As remaining trade barriers are dismantled, the reallocation of resources to the more competitive sectors would help to increase average productivity in the economy and improve welfare of consumers through lower prices and access to better quality products. A condition for this is efficient labor, land and capital markets to ensure a smooth resource reallocation from shrinking activities to expanding activities. It is impossible to predict which activity or sector will ultimately shrink or expand, and even if it was possible it would be of limited use for policy purposes - the overall efficiency of factor markets remains the key policy objective. However, it may still be interesting to assess short-run potential sectoral effects of trade liberalization.

3.37 While the net effect of trade liberalization should be overall positive, some sectors may experience especially high rates of import growth and could face severe problems when faced with stringent competition. Generally, sectors that may be hit hard are the ones highly protected, as well as those that cannot be competitive based on relative factor endowments. To illustrate which sectors may experience increased competition from imports, a simplified static framework that focuses only on the effects of the removal of tariffs on imports of goods was considered. Table 3.3 presents the expected short-run increase of preferential imports based on different assumptions of import elasticities;<sup>48</sup> estimated effects are then multiplied by a factor which varies inversely with transport cost estimates.<sup>49</sup> For agricultural products and food, there is the additional assumption that tariffs would not be fully eliminated, but reduced by half.

3.38 Textile products, footwear, beverages, and tobacco are the leading sectors most likely to experience a significant increase of imports due to trade liberalization. Also, petroleum refining and metal products, construction materials and wood products may experience increased imports due to the elimination of rather high existing tariffs.

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<sup>48</sup> Two elasticity factors were used: 1.2 and 2. Empirical tests have shown that the long-run trade price elasticities in different countries are in the range from 1.25 to 2.50, i.e., high, while short-run elasticities are smaller approximately by half. The demand elasticities are significantly higher for consumer goods than for industrial ones.

<sup>49</sup> Transport costs were assigned a factor of 1, 2 or 3 depending on a ranking of transport costs incidence on import prices. The elasticity factor then was multiplied by the inverse of the transport cost factor. See K. Jurlin and D. Galinec (2002).

However, trade in the latter products is significantly hindered by transport costs that significantly decrease the expected rates of imports' increase.

3.39 In any case, this is only a preliminary assessment of the initial effects. A more thorough analysis ought to incorporate a more detailed analysis of transport costs, the impact on transport costs of future investments in transport infrastructure, the effects of improvements in custom's administration, the scope for domestic restructuring which may lead domestic producers to cut prices, increased cooperation with EU firms. In addition, over time, domestic producers may decide on new investments or product reorientation. In particular, if Croatia were to follow the experience of CEECs, *Croatian trade should become more of the intra-industry type*, i.e., with similar products in both exports and imports. According to Astrov (2001), based on an analysis of the sectoral structure of exports and imports of Croatia compared to that of CEECs, trade there appears to be room for a substantial increase of intra-industry trade.

3.40 An alternative approach to assess potential trade developments is to look at the factor contents of trade. Apart from the sectors that recorded significant growth in recent years (tourism, communication equipment, pharmaceuticals), the potential for exports for example may depend on factor endowments. Galinec et al., (2002) conducted an analysis of factor content of Croatian exports, showing that Croatia is a net exporter of labor, and net importer of the more advanced factors of trade in scale and technology, which is more pronounced in trade with the EU.

3.41 As evident from Table 3.4, most of the intra EU trade and EU imports from the rest of the world is based on skills, technology, and scale. While only 20 percent of intra EU trade and 23.5 percent of EU imports from CEE countries is based on labor, the labor content of Croatian exports to the EU is as high as 34.5 percent. Most Croatian exports to the EU are textiles, clothing and footwear, as is also the case with most SEECs. Compared to total EU imports, as well as to EU imports from the CEECs, Croatia lags behind in exports of more advanced products (machinery, electrical appliances, instruments and vehicles).

3.42 Assuming that "new" competitive sectors will be those that are currently significantly under-represented when compared to the most successful CEECs, i.e., that the product structure of Croatian exports to the EU would restructure to become similar to the average structure of the advanced CEECs (CEE4) or even Portugal,<sup>50</sup> the product group with the highest potential for exports is vehicles, making for 17.6 percent of CEECs exports to the EU, and a mere 1.6 percent of Croatian EU exports (Table 3.5). A very significant break is also evident for machinery, with a 9.1 percent gap, electrical machinery and equipment with 6.3 percent and mineral and metal products, with a 3.1 percent gap. These sectors obviously have a long-term potential to increase their share in total Croatian exports. Labor intensive activities such as clothing and footwear, as well as

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<sup>50</sup> Although Greece may also have served as an example, having a moderate GDP per capita and strong services export, we chose not to include it in our analysis because its exports are strongly biased towards agriculture products, and the export structure with a lack of more advanced products, probably due to peripheral position in the EU and low intra-industry trade in advanced products.

**Table 3.3: Estimated Static Sectoral Effects of Trade Liberalization (% Increase in Volume)**

	(1)	(2)	(3)	(4)	(5)	(6)
Electricity	0	0.0	0	1	0.0	0.0
Extraction of coal	0	0.0	0	3	0.0	0.0
Coal processing	0.08	0.1	0.16	3	0.0	0.1
Production of crude petroleum and gas	0.98	1.2	1.96	3	0.4	0.7
Petroleum refining	13.45	16.1	26.9	3	5.4	9.0
Extraction of iron ore	0	0.0	0	3	0.0	0.0
Iron and steel	1.64	2.0	3.28	3	0.7	1.1
Non-ferrous mining	4.66	5.6	9.32	3	1.9	3.1
Non-ferrous metal production	0.05	0.1	0.1	3	0.0	0.0
Non-ferrous metal processing	4.94	5.9	9.88	2	3.0	4.9
Extraction of minerals	3.64	4.4	7.28	3	1.5	2.4
Processing of minerals	7.65	9.2	15.3	3	3.1	5.1
Manufacture of metal products	9.05	10.9	18.1	2	5.4	9.1
Machinery	3.07	3.7	6.14	1	3.7	6.1
Transport equipment	7.75	9.3	15.6	1	9.3	15.5
Shipbuilding	0.85	1.0	1.7	1	1.0	1.7
Electrical equipment	4.2	5.0	8.4	1	5.0	8.4
Basic chemistry	4.8	5.8	9.6	3	1.9	3.2
Chemical products	6.35	7.6	12.7	2	3.8	6.4
Stone, gravel and sand quarrying	7.77	9.3	15.54	3	3.1	5.2
Construction materials	8.62	10.3	17.24	3	3.4	5.7
Timber	1.42	1.7	2.84	3	0.6	0.9
Finished wood products	9.66	11.6	19.32	2	5.8	9.7
Paper and products	6.09	7.3	12.18	2	3.7	6.1
Textile fibre and fabric	6.78	8.1	13.56	1	8.1	13.6
Textile products	17.68	21.2	35.36	1	21.2	35.4
Leather and fur	3.02	3.6	6.04	1	3.6	6.0
Leather footwear and accessories	14.61	17.5	29.22	1	17.5	29.2
Rubber	5.81	7.0	11.62	1	7.0	11.6
Food products	13.86	8.3	13.86	2	4.2	6.9
Beverages	26.57	15.9	26.57	2	8.0	13.3
Animal fodder	17.07	10.2	17.07	3	3.4	5.7
Tobacco	23.04	13.8	23.04	1	13.8	23.0
Printing	8.78	7.9	17.56	2	4.0	8.8
Recycling of industrial waste	7.03	6.3	14.06	3	2.1	4.7
Miscellaneous products	9.29	8.4	18.58	1	8.4	18.6
Agriculture and fisheries	3.61	2.2	3.61	2	1.1	1.8
Forestry	1.8	0.7	1.18	3	0.2	0.4

*Notes:*

- (1) Average tariff (2002).
- (2) Expected rate of import's increase (elasticity=1.2).
- (3) Expected rate of import's increase (elasticity=2).
- (4) Transport costs factor.
- (5) Expected rate of import's increase after transport costs (elasticity=1.2).
- (6) Expected rate of import's increase after transport costs (elasticity=2).

*Source:* Central Bureau of Statistics and World Bank staff estimates.

the resource intensive chemical industry and wood may, on the other hand, lose their shares once Croatian exports restructure following the CEECs path.

**Table 3.4: Factor Content of EU Imports From Selected Regions, 1998 (in %)**

	Resources	Labor	Skills	Technology	Scale
Intra EU trade	9.76	20.03	25.27	27.99	16.96
Extra EU imports	13.01	18.99	26.42	25.03	16.56
EU imports from CEECs	11.37	23.54	24.58	26.20	14.30
EU imports from Croatia	12.64	34.53	22.66	21.33	8.83

Source: Eurostat COMEXT.

**Table 3.5: Structure of the CEECs Export to the EU, and “Gap” in Croatian Exports (% change)**

		Vehicles	Machinery and mechanical appliances	Electrical machinery and equipment	Mineral and metal products	Precise instruments	Other	Agriculture and food products	Minerals and fuels	Wood, pulp, paper, furniture	Chemical products, plastic and pharmacy	Textiles, clothing, footwear
Croatia	<b>1993</b>	3.6	2.5	4.1	8.0	0.4	2.0	5.5	8.8	13.4	14.4	37.3
	<b>2000</b>	1.6	5.9	8.8	10.9	0.9	1.0	2.7	5.3	16.1	14.1	32.7
	<b>CHANGE</b>	<b>-2.0</b>	<b>3.4</b>	<b>4.7</b>	<b>2.9</b>	<b>0.5</b>	<b>-1.0</b>	<b>-2.8</b>	<b>-3.5</b>	<b>2.7</b>	<b>-0.3</b>	<b>-4.6</b>
Gap vs. Ceec4	<b>1993</b>	-4.5	-5.6	-3.7	-10.6	-1.0	-0.2	-1.7	5.2	1.8	3.2	17.1
	<b>2000</b>	<b>-17.0</b>	<b>-10.1</b>	<b>-7.5</b>	<b>-2.6</b>	<b>-0.7</b>	<b>-0.4</b>	<b>0.2</b>	<b>3.1</b>	<b>5.9</b>	<b>6.3</b>	<b>22.7</b>
Gap vs. Portugal	<b>1993</b>	-3.4	-2.2	-3.4	0.7	-0.3	1.7	-1.9	6.8	-4.0	7.4	-1.3
	<b>2000</b>	<b>-20.5</b>	<b>1.4</b>	<b>-3.4</b>	<b>3.4</b>	<b>0.0</b>	<b>-4.3</b>	<b>-3.3</b>	<b>3.9</b>	<b>4.9</b>	<b>7.3</b>	<b>10.4</b>

Source: Staff calculation, based on COMEXT data.

3.43 Note that CEECs exports structure has significantly changed, with an increase of the share of the advanced products, namely vehicles, machinery and electrical products of almost 25 percentage points. This was at the expense of labor intensive products (textiles, footwear, agriculture, food products, mineral and metal products) which declined about 20 percentage points. Portugal experienced a similar trend in the 1988-2000 period.

## E. FOREIGN DIRECT INVESTMENT - FDI

3.44 FDI is a key channel through which Croatia will be able to intensify its economic integration process. The dynamic effects of trade will be largely achieved through FDI that brings capital, technology, knowledge, opportunities for skill's enhancement as well as regional marketing and distribution networks. From a macroeconomic point of view, FDI flows will in addition become an important source of aggregate investment and external financing. FDI flows are the more stable of all types of capital flows.

3.45 Foreign investments in Croatia are regulated by the Company Act. Foreign investors have the same rights, obligations and legal status within an enterprise as domestic investors. The Constitution states that rights acquired through capital investments cannot be withdrawn by law or any other legal act. It also ensures that there may be unrestricted repatriation of profits and free repatriation of capital on disinvestment after all legal obligations in Croatia have been met.

3.46 With a cumulative FDI inflow in 1994-2000 estimated at US\$1,187 per capita,<sup>51</sup> Croatia ranks high among the transition economies. For example, it is well above Slovenia, the Slovak Republic, Romania, Bulgaria and Poland although below the average of the Czech Republic and Hungary. Total net capital inflows during the 1994-2001 period were US\$15.5 billion of which FDI represented 37 percent (Table 3.6). While FDI inflows were slightly above US\$100 millions per year in the 1993-1995 period, they have increased to above US\$ 500 million in 1996 and 1997. After obtaining a sovereign rating in early 1997, and due to large privatization projects and mergers/acquisitions, FDI inflows rose to over US\$1 billion annually in 1999-2001.

**Table 3.6: Composition of Net Financial Flows to Croatia by Types of Investment**

Million USD and %	1994	1995	1996	1997	1998	1999	2000	2001	1994-2001
Financial account, excl. reserves	481.4	1,538.8	2,512.3	3,058.2	1,601.5	2,644.9	1,488.3	2,213.3	15,538.6
1. Direct investment, net	1,10.2	108.8	486.4	346.7	834.9	1,444.6	1,086.2	1,325.4	5,743.2
2. Portfolio investment, net	10.9	4.9	628.3	557.0	14.9	574.0	722.2	716.0	3,248.2
3. Other investment, net	360.3	1,425.1	1,397.6	2,134.4	751.7	626.3	-320.1	171.9	6,547.2
Financial account, excl. reserves (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1. Direct investment, net	22.9	7.1	19.4	11.3	52.1	54.6	73.0	59.9	37.0
2. Portfolio investment, net	2.3	0.3	25.0	18.9	0.9	21.7	48.5	32.4	20.9
3. Other investment, net	74.8	92.6	55.6	69.8	46.9	23.7	-21.5	7.8	42.1

Source: CNB Bulletin No. 72.

3.47 The leading countries from which FDI inflows have originated are Austria (27.2 percent), Germany (25.8 percent) and the USA (18.2 percent). Most investments were into existing companies that were previously successful or holding interesting markets, i.e., investments were not directed towards new production facilities. Most FDI to date has been concentrated in a few large privatizations such as "Croatian Telecom", "Pliva" (pharmaceutical company), and three large banks (Riječka banka, Splitska banka and Privredna banka Zagreb). The privatization process resulted in a high share of foreign ownership in many sectors including banking (28 percent of total foreign direct investment within 1993-2001 period), transport, storage and communication (21.1 percent), manufacture of chemicals and chemical products (14.9 percent) and the manufacture of other mineral products (7.3 percent).

3.48 "Greenfield" investment, especially in export-oriented branches, has been low – 13.2 percent of total FDI inflow in 1993-2001. The low share of "greenfield" and lack of "brownfield" investments in tradable sectors in Croatia suggests that FDI may have had a limited impact on exports of goods. While with US\$1,500 FDI stock per capita in 2001 and an FDI-GDP ratio of 33 percent Croatia has surpassed even the average of CEE5, FDI flows did not play an important role in exports. At 16 percent of exports, the share of

<sup>51</sup> According to official FDI statistics (compiled by CNB), the cumulative FDI inflow in the period 1993 – 2001 is estimated at US\$6.64 billion (or US\$1516.7 per capita).

FDI firms is low compared to the shares of CEECs – 60 percent for Czech Republic and Poland, 89 percent for Hungary, 33 percent in Slovenia and 35 percent in Estonia according to Hunya (2002).

3.49 The largest share of FDI firms in exports is recorded in manufacturing with the stock of FDI reaching US\$2.1 billion (31.8 percent of total FDI inflows) in 2001. The largest investments in manufacturing (and their share in sectoral exports) were chemical products (US\$993 million, 38 percent of exports), non-metallic mineral products (US\$485 million, 66 percent of exports), food products and beverages (US\$205 million, 7.2 percent of exports), electrical machinery and apparatus (US\$137 million, 48 percent of exports), and radio, TV and communication equipment (US\$68.9 million, 35 percent of exports). The effects of FDI on exports of these manufacturing subsectors has not been significant. The largest investments into the chemical products sector in 1996 and 1998 did not impact on exports and, after 1995, annual exports of this sector dropped. The trends in the share of exports of the other branches were, with the exception of food products and beverages, positive but from overall low initial levels.

3.50 It appears that in the period under review the driving force of FDI in Croatia was access to domestic markets with the focus more recently shifting to the banking sector and telecommunications sector following the privatization initiatives in these sectors. This experience of low “greenfield” operations with limited impact on exports contrasts with the experience of the CEECs where FDI was far more oriented towards “greenfield” operations which contributed through exports to the integration into particular chains of production based on their mix of relative high skills and low labor costs in conjunction with the proximity to EU markets. It is possible that as the privatization phase of FDI is drawing to a close – as pending sales of the insurance, electricity distribution and petroleum companies over coming years materialize – the scope for “greenfield” operations in export-oriented activities in Croatia may gain significance.

3.51 One key question is whether in such cases FDI will be directed towards activities characterized by revealed comparative advantage, such as in the case of Croatia, export activities like wearing apparel, shipbuilding, petroleum processing and leather industry – or rather – as has been the case in Central Europe – to activities determined by relative factor endowments. According to the new economic geography (Krugman and Venables, 1995), scale economies, industrial linkages and costs of trade are bound to be the main parameters for firm location. Others like Ellingsen and Warneryd (1999) found that proximity to the EU is a very important determinant of FDI – explaining why investment has gone largely to the countries close to the EU.

3.52 The main Croatian export-oriented manufacturing sectors that were attractive to FDI investors were pharmaceuticals, communication and electrical equipment. However, these sectors were competitive even before FDI through trade and contracting links with the leading Western companies. Since FDI in these sectors was mostly linked to privatization, rather than having an impact on capacity or technology transfer, the main effect of investment has been through stretching links with foreign counterparts and markets. Interestingly, Croatia has also become an important FDI investor abroad in the pharmaceutical sector. With a cumulative stock of Croatian FDI abroad of US\$550

million in 2001, about 44 percent of it is in the pharmaceutical sector (investments are located in Poland, Hungary, U.K. and Denmark).

3.53 Why was FDI in tourism so low - 2.2 percent of FDI in 1993-2001? Given that tourism represents almost half of Croatia's exports, it is worth asking why more FDI has not been directed towards it. Possible reasons are:

- (a) There is still excess capacity relative to pre-independence levels.
- (b) Complex ownership structure of existing firms– no majority shareholder.
- (c) Large arrears requires big discounts to investors.
- (d) Unsolved land ownership and spatial planning hinders “greenfield” operations.

3.54 Policy implications are that lack of resolution of land ownership, soft budget constraints and corporate governance issues constitute a major obstacle to FDI in the service sector which is the single most important generator of foreign exchange – tourism.

3.55 More generally, aside from all the domestic administrative barriers to investment (discussed in Chapter 5), the single most important obstacle for attracting export-oriented FDI is the impossibility to apply the PCO System benefits to Croatian exports (see Box 3.1). As part of the European Agreements, the EU eliminated duties on imports of textile and clothing products originating from CEECs in early 1997 and all remaining quantitative restrictions in early 1998. It eased the market access to the EU market for textile and clothing from CEECs, while Croatia couldn't reach an agreement on trade in textiles until 2000.<sup>52</sup> Because Croatia was not covered by the PCO System, in order to prevent circumvention of textile trade and to ensure the actual Croatian origin of the products, the most sensitive textiles products for the EU became subject to double-checking (licensing).

## **F. POLICY ISSUES**

3.56 Croatia has already advanced to implement crucial FTAs to integrate its economy into the free trade area emerging across much of Europe; encompassing the EU, CEFTA, EFTA and the SEECs. Any quantitative assessment of the short, medium and long-term impact effects of such processes is at best tentative. However, both quantitative and qualitative analyses suggest that aggregate trade will increase and with it the opportunities to reap the benefits of greater economic efficiency, welfare and growth. The crucial question in the course of implementation of SAA is which policy changes are necessary to maximize benefits and minimize costs in the field of trade and FDI. As the previous analysis has shown, there is a need for a proper mix of policy measures to

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<sup>52</sup> European Commission and the Republic of Croatia only concluded the Agreement on trade in textile products, Brussels, November 8, 2000.

stimulate investment in the new export facilities, as well as to stimulate overall competitiveness.

3.57 Is trade policy and FDI policy on the right track? The answer is positive, as was discussed in Section A, but there is scope for further and/or faster trade liberalization, particularly through lowering tariffs of MFN trade partners not covered by FTAs to EU levels. Similarly, the asymmetric nature of the SAA could be unilaterally reversed to increase welfare in Croatia. SEECs could also step up attempts to pursue more efficient multilateral trade liberalization arrangements, like seeking a single FTA for all former Yugoslavia countries for example or consolidating individual FTAs through adoption of common rules and exceptions. In the case of Croatia, joining CEFTA has partially addressed some of the related issues (though not those with SEECs). Regardless of progress in these areas, Croatia needs to keep pushing ahead with the multilateral liberalization agenda under WTO.

3.58 Finally, in the context of SAA, Croatia (and the other SEECs) could benefit strongly from joining the EU system of diagonal cumulation of rules of origin (PCO System). Inclusion of Croatia in the PCO System should strengthen the economic relations between Croatia and the EU, due to the fact that the EU is Croatia's largest trade partner and that majority of FDI inflows originate in the EU. Croatia should thus seek to join the PCO. This would, however, require the approval of all EU member countries.

3.59 Attracting FDI inflows is the cornerstone of Croatia's recent economic reform program. The new Government understands that FDI can contribute to the improvement of competitiveness and job creation and is determined to accelerate FDI inflows through the introduction of investment incentive legislation, the reduction of payroll and corporate tax, the revision of the privatization framework, and further liberalization of the telecommunications and energy sectors. Croatia has adopted tax legislation which is quite competitive vis-à-vis the CEECs – a 20 percent corporate rate and a 15 percent dividend tax that encourages reinvestment of dividends. Croatia has also adopted a fairly comprehensive scheme that benefits investors (not just FDI) in new companies through tax and custom's benefits. A new draft of the Investment Incentive Act proposes to enlarge the list of companies eligible to include existing companies; it also lowered the minimum investment thus avoiding preferential treatment to new large investments. The overall fiscal impact of this scheme, though, is yet to be assessed and must also be borne in mind if this policy is to be sustained.

3.60 The Government is also working on the further elimination of certain administrative barriers pointed out in the recent FIAS study "*Croatia – Administrative Barriers to Foreign Investment*" (2001). The study determined several areas of administrative barriers to investment including practical recommendations on entry procedures – elimination of multiple procedures regarding issuing of business and employment visas for foreigners, company registration and business establishment procedures—providing an expedite service at Commercial Court, and land acquisition, registration and site development—reduction of time required to establish clear ownership situation, improvement of coordination between land acquisition and construction permit procedures (see Chapter 5).

3.61 To further facilitate trade, Croatia ought also to:

- Strengthen the Export Development Agency by pairing up its efforts with embassies and consulates to support private firms' export efforts, particularly SMEs. The Agency could also improve coordination between SMEs with similar interests, e.g., to form export cooperatives, disseminate best practice in export activities, organize courses, and facilitate international electronic commerce.
- Continue to improve custom's arrangements through better use of available software, dynamic border controls through random checks at border points, better coordination between custom officers and border police, reduce delays in the construction of new border crossings (more recommendations in Chapter 7).
- Improve the efficiency and lower the cost of transport systems (specific recommendations in Chapter 7).

## **4. BUILDING A MODERN PUBLIC ADMINISTRATION**

4.1 Croatia's need for reforming and modernizing its public administration is strategically important in the context of European integration for at least three important reasons:

- (a) Prospective members must attain sufficient administrative capacity to implement the commitments under the SAA.
- (b) Public expenditure needs to be reduced to improve debt and fiscal sustainability.
- (c) Policy management and coordination needs to be strengthened.

4.2 The emphasis in the analysis that follows is placed on determining whether the public administration can operate at a strategic level and whether it is capable of carrying policy directions through to implementation. Croatia's significant economic and social challenges will only be met if these fundamental capacities are developed and sustained within the public administration.

4.3 This chapter will explore progress and challenges in three critical areas of public administration reform: restructuring government (Section A), modernizing the civil service (Section B), and strengthening policy management (Section C). Section D discusses issues on strengthening regional and local self-government and how these efforts should be integrated with the overall reform and how reforms should be sequenced.

### **A. RESTRUCTURING GOVERNMENT**

4.4 The transformation of a public service from one that supports the ruling party in a command and control economy to one that is organized around the principles of citizen-centered government in a market economy requires far-reaching changes in organization and behavior. The Government will need to determine the continuing relevance of current functions, the optimal delivery of new functions, and the functional realignment necessary to implement wide-ranging economic and social policy reforms. Forces driving this change include European integration, globalization, fiscal reform, and the changing policy environment attendant with transition.

4.5 This section describes the current size, cost, and organization of the Croatian public service. Measured as a proportion of Croatia's population, the number of civilian public servants does not appear to be excessive when compared against other CEECs. By contrast, the general government wage bill as a percentage of GDP is very high in

comparative terms. Two possible causes of this are explored: overstaffing in non-civilian areas and high salary levels. To explore the issue of wage levels, a more detailed assessment is provided comparing staffing and wage levels in specific institutions, at different job levels, and between the public and private sectors. In terms of organization, Croatia's public service remains ill-equipped to deal with the challenges of complex policy formulation and delivery attendant with European integration and the global economic system. Policy recommendations are summed up at the end.

### **Staffing Levels**

4.6 In 2001, there were 180,464 employees in central government and 276,611 in general government (includes local government and several off-budget agencies; health services is by far the largest). Approximately 80 percent of central government staff are located in four ministries (Education and Sports; Defense; Interior; Justice, Administration and Local Government). With respect to relative numbers of public employees, cross-country data must be approached with extreme caution as numerous factors can distort the comparison.<sup>53</sup> Nonetheless, at 4.9 percent of population, Croatia's level of civilian government is right at the (unweighted) average of a sample of seven comparable countries.<sup>54</sup>

4.7 This suggests that a possible problem lies in the non-civilian public sector. Although comparable data on such areas as defense, police and intelligence service staffing are not easily obtained, the comparison between Croatia and Slovenia suggests this to be the case: while Croatia has 6.5 per thousand of population Slovenia has 4.3 per thousand. As Croatia continues its transition to a peacetime status, its ratio should begin to move towards Slovenia's. The Government has indeed targeted non-civilian employment for its first wave of downsizing. The Government's plan anticipates cutting by more than half Defense staff and by one-fourth Interior staff. Evidence to date suggests that concrete progress is being made (staffing levels in Defense dropped by 5.3 percent between 2000 and 2001; and by 6.6 percent in Interior), although not at the pace initially envisioned.

### **Wage Bill Levels**

4.8 The consolidated general government (CGG) wage bill in Croatia is strikingly higher than in other CEECs and continues to consume a disproportionate share of GDP: 11.9 percent of GDP compared to 5.1 percent in Bulgaria, 5.5 percent in Romania and 9.1 percent in the Slovak Republic (2001 data). Having peaked in 2000, the wage bill as a percentage of GDP began to decline in 2001 and again in 2002 owing to the Government's salary containment strategy. In the previous standby agreement with the

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<sup>53</sup> In terms of overall general government, differences may exist in the treatment of armed forces, intelligence services, contract employees, part-time employees, employees paid through own revenues, and employees engaged in commercial activities. In terms comparing central governments, the division of powers with municipalities must be taken into account.

<sup>54</sup> Moldova (5.2 percent), FYR Macedonia (4 percent), Hungary (7.6 percent), Lithuania (8.3 percent), Poland (2.7 percent), Romania (2.7 percent) and Slovenia (3.7 percent).

IMF, commitments for a nominal 10 percent reduction in the CGG wage bill and cuts of 10,000 employees were agreed to for 2001 but were not carried out as planned. This staff reduction is now envisaged to take place in 2003 under the current stand-by arrangement. In sum, the continuing discrepancy between Croatia's public service wage bill versus other CEE countries can be attributed both to the size of the non-civilian public sector and comparatively high salaries.

4.9 The overall wage policy in Croatia is characterized by higher than average increases. Real gross wages grew at an average of 13.5 percent annually between 1994 and 1999. By comparison, real gross wages in Slovenia, Hungary, the Czech Republic, and Poland all grew by less than 5 percent (Institute of Economics, 2000). In Croatia, since 1993, the major driver of this increase has been public sector salaries which have substantially outpaced the private sector in wage gains.

4.10 One rationale for the higher public sector wages is the relatively higher education levels in that sector (49 percent with university/college degrees vs. 13.9 percent in the business sector), but even if education and other factors are controlled, only the financial sector outstrips public administration (Croatia PEIR 2002).

### **Compensation Policy**

4.11 The wage bill problem derives from an uncontained compensation policy pursued by successive governments through the late 1990s, exacerbated by inconsistent application between similar jobs in different organizations and disregard of the salary regulations that did exist. With new salary laws, a concerted attempt to gain control over compensation was made by the Government in 2000, although the impact of these efforts is just beginning to emerge. 2001 marked the first decline in the average monthly gross wage in public administration and the health sector although the education sector did register a small advance.

4.12 The Government's ability to sustain wage containment is being tested as pressures mount for exceptions to the more stringent system by individual occupational groups. Although the Government has attempted to move towards unified salary bargaining for the civil service, in the broader public sector, traditional collective bargaining pattern by multiple occupational groups (doctors, teachers, etc.), is reasserting itself with the negotiation of addendums to the main agreement and pressures for adjustments to wage supplements or job complexity coefficients.

4.13 Other potential sources of Croatia's high wages are the different practices among organizations in classifying jobs and assigning complexity coefficients. Similarly, there are variations concerning the number of state officials and the distribution of hierarchical job levels between organizations. For instance, the Customs function (Ministry of Finance) with approximately 3,000 employees is managed through one state official

while the State Weather Bureau (426 employees) and Central Bureau of Statistics (385 employees) have six and 10 respectively.<sup>55</sup>

### **Recruitment, Retention, and Salary Levels**

4.14 Croatia does not have a generalized problem of high turnover in its public administration. This is partly due to relatively high salaries—relative to the private sector—and partly due to relatively low salary compression (i.e., a high ratio between the highest and lowest salary) broadly in line with OECD levels (between 6 and 9).

4.15 Croatia has, however, isolated cases of high turnover. Some of the most visible cases are: macroeconomic forecasting and analysis at the Ministry of Finance; IT at the Ministry of Labor and Social Welfare and Ministry of European Integration. One characteristic of the new compensation system that has been blamed in some quarters for encouraging turnover, especially among the young, is the strong reliance on years of service as a key determinant of salary and promotion.<sup>56</sup> Although a case can certainly be made for rewarding experience, if it remains a primary determinant of salary and promotion, this may serve as a disincentive to high flyers or those in in-demand occupations.

4.16 Another compensation problem arises when different organizations within the civil service have widely varying pay levels for similar jobs. Aside from inhibiting intra-service mobility, it creates pressure in the lower paying organizations to match the higher paying organizations. In Croatia, the goal of a uniform civil service pay system remains elusive. Although the new law did ostensibly reduce the number of job levels to seven across the service, different job complexity coefficients<sup>57</sup> are used by different organizations for the same job level. In terms of the number of different job complexity coefficients used within a category, a survey of the Ministry of Labor and Social Welfare identified 17 different coefficients within the seven job levels. For example, the highest job coefficient in higher education may be paid at 3.5 times basic salary; for the Ministries of Defense and Interior 2.60 and at 2.2 for the Ministry of Environmental Protection and Zoning.

4.17 The multiplicity of pay systems across countries makes comparison difficult, but generally other CEECs' systems have moved towards a higher level of uniformity across the civil service. There is no one prescription that can be imported for Croatia, but the next generation of compensation reforms should certainly move strongly towards uniformity across organizations and more clearly differentiate categories within job

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<sup>55</sup> This is partially attributable to Customs being located within the Ministry of Finance rather than existing as a separate agency. However, this raises the issue of agency review with respect to the rationale, mandates, reporting relationship, management structure, and staffing levels of the current agency configuration. Another source of pressure on the wage bill comes at the assistant minister level. Assistant ministers are sometimes appointed to manage units without the legally required minimum two departments, each with a minimum of nine employees.

<sup>56</sup> Some advancements are precluded until five and 10 years of experience have been obtained.

<sup>57</sup> These are used to determine salary by multiplying the coefficient by the basic pay rate set by Parliament and topped up by 0.5 percent for each year of service.

levels. At the same time, the system must not be so inflexible that occupational discrepancies cannot be addressed.<sup>58</sup>

### **Wage and Compensation Policy – Achieving the Right Balance**

4.18 The urgency of placing Croatia on a sustainable fiscal path will necessarily maintain the focus on wage bill and compensation policy issues. This will require significant improvements in human resources and payroll data collection and analysis. Otherwise, it will be difficult to develop an informed wage bill strategy as part of the Government's fiscal plan. Salary impact simulations should be more widely available to assist with fiscal planning, collective bargaining, and human resources management. Occupational trends and comparisons with the private sector and other countries should be routinely tracked. Without this analysis, upward fiscal pressures, damaging turnover incentives, or critical skills gaps may be inadvertently created as a result of ill-informed compensation policy changes or fiscally-driven decisions.

4.19 Given the high impact of the wage bill on the Government's fiscal outlook, it is critical that compensation policy be acknowledged as a major cost driver in determining the annual budget strategy. A multi-year strategy is required. Extensive experience with wage reduction among CEECs provides a range of models that can be drawn upon to contain or reduce the wage bill.<sup>59</sup>

### **Organization and Functions of Croatia's Public Service**

4.20 From a fiscal perspective, overstaffing of non-civilian institutions, high overall wages and structural problems in job grading and compensation may be the most important public administration restructuring issues. However, other reforms are at least as important – even if perhaps not so relevant from a fiscal dimension. The structure and mandates of Croatia's public service are falling short with respect to strategic decision-making and overall economic policy and, more generally, with respect to meeting the demands of a transition economy and European integration.

4.21 The trend in CEECs towards smaller numbers of ministries is typically felt to offer benefits with respect to improved policy coordination and internal efficiencies (e.g., reduction in internal administration costs). With 19 ministries, the Croatian Government is the second largest among a broad group of 14 SEECs and CEECs excluding Romania and

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<sup>58</sup> In Canada, for example, special salary scales were developed for occupations that were being remunerated at a much higher level in the private sector (e.g., lawyers). These scales remain within the uniform salary system as they apply to all organizations under the public service salary regime. Another related issue is the comprehensiveness of the civil service compensation scheme, i.e., if fully applied to organizations such as the Central Bank, Constitutional Court, or Supreme Audit Institution, recruitment and independence problems can arise.

<sup>59</sup> The World Bank produced a policy paper for the Government of FYR Macedonia outlining the pros and cons of 20 approaches to wage reduction exercises in late 2000.

Croatia; the average was 14 ministries.<sup>60</sup> Clearly, there is a case to be made for some amalgamation.

4.22 Although there is no definitive configuration, a consolidated model can be provided that reflects a common configuration in several CEECs (the Czech Republic, Estonia, Hungary, Lithuania). If these configurations are broken out by policy cluster (Table 4.1), this comparison strikingly reveals that Croatia's high number of ministries can be attributed to its economic cluster of nine ministries, as compared to the common model of five. Such fragmentation of economic portfolios likely contributes to poor coordination across this vital policy area and would certainly be a priority area to explore for consolidation.

4.23 It should be emphasized that gaps in economic policy formulation will not be resolved simply by amalgamating several ministries. The whole policy field needs to be reviewed with a view to determining where and how overall economic policy should be developed and how the various sub-components of that policy field should inter-relate and be reflected organizationally among ministries, agencies, and extra-budgetary funds.<sup>61</sup>

4.24 Currently, overall responsibility for economic policy is not strongly in evidence in any government organization. The Deputy Prime Minister for Economy has a coordinating responsibility, but few staff. The Prime Minister has two economic advisers. The Ministry of Finance only has one person in its Macroeconomic Analysis and Planning Department (more hiring is planned) and the Ministry of Economy focuses on investment, privatization and specific industrial sectors. At the same time, the Ministry of European Integration is coordinating the harmonization of legislation to meet EU standards, resulting in significant changes to the way in which various economy-related functions are delivered (e.g., company law, competition policy, intellectual property rights).

4.25 This raises another critical organizational issue: how regulatory functions should be delivered. The *acquis* requires a vast array of regulation that will not have traditionally been delivered by CEECs' governments. Typically, the specific form of organizational option is not prescribed, simply the requirement for an organization or simply the requirement that regulation occur. In determining the optimum regulatory model for Croatia, issues such as the legal framework, conflicts of interest, accountability mechanisms, transparency, contract monitoring capacity within the responsible ministry, service quality, multi-year cost, self-financing potential, and staff skill/salary requirements will need to be considered. Hungary is one of the most advanced accession countries with respect to developing the necessary regulatory structures for a market economy (see "Croatia-Building a Modern Public Administration," 2002).

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<sup>60</sup> Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, Ukraine, Estonia, Croatia, FYR Macedonia, Latvia, Lithuania, Moldova and Slovenia.

<sup>61</sup> (PEIR 2002) recommends inclusion of all extra-budgetary funds within the state budget.

**Table 4.1: Comparison of Croatia's Ministry Configuration/Common CEE Configuration**

<b>Current Ministry Configuration – Government Of Croatia</b>		
<b>Internal &amp; External Affairs</b>	<b>Social Affairs</b>	<b>Economy</b>
<ul style="list-style-type: none"> <li>• Defense</li> <li>• European Integration</li> <li>• Foreign Affairs</li> <li>• Interior</li> <li>• Justice, Administration and Local Self Government</li> </ul>	<ul style="list-style-type: none"> <li>• Culture</li> <li>• Education and Sports</li> <li>• Health</li> <li>• Homeland War Veterans</li> <li>• Labor and Social Welfare</li> </ul>	<ul style="list-style-type: none"> <li>• Agriculture and Forestry</li> <li>• Crafts, Small and Medium Enterprises</li> <li>• Economy</li> <li>• Environmental Protection and Zoning</li> <li>• Finance</li> <li>• Maritime Affairs, Transportation and Communications</li> <li>• Public Works, Reconstruction and Construction</li> <li>• Science and Technology</li> <li>• Tourism</li> </ul>
<b>Common Ministry Configuration – CEE</b>		
<ul style="list-style-type: none"> <li>• Defense</li> <li>• Foreign Affairs</li> <li>• Interior</li> <li>• Justice</li> </ul>	<ul style="list-style-type: none"> <li>• Culture</li> <li>• Education</li> <li>• Health</li> <li>• Labor and Social Welfare</li> </ul>	<ul style="list-style-type: none"> <li>• Agriculture</li> <li>• Economy/Industry</li> <li>• Environment</li> <li>• Finance</li> <li>• Transportation</li> </ul>

\* In this configuration, European integration and public administration reform are delivered through directorates at the center of government.

Source: Ministry of Justice and World Bank staff.

4.26 Other areas where restructuring is typically required in transition countries include:

- divesting commercial activities within ministries (often funded by own revenues);
- decentralization in support of local self-government;
- agency reform;
- strengthening central agencies;
- modernizing the judiciary;
- redeployment strategies to move and retrain redundant employees; and
- establishing new bodies to meet EU standards(e.g., competition bureau, procurement office).

4.27 Although there are both urgent fiscal and policy rationales for public administration restructuring, caution must be exercised on the scope of the exercise, its leadership, how it is managed, and its relation to fiscal objectives. Parison & Manning (2001) provide a stark reminder of how many such initiatives have failed to deliver the intended results. Of paramount importance to the Government will be the decision on *who will lead this complex process* that affects every corner of government and how decisions will be finalized and enforced. Technical assistance would be beneficial to assist with setting up and initiating a reform of this magnitude.

## Policy Recommendations

4.28 The main policy recommendations are:

- Strategies related to the size, cost and organization of the public service must be closely linked to the *annual budget process and efforts to advance budget reform*, including stronger priority-setting and multi-year planning. The whole issue of government restructuring, linked to *wage bill and compensation policy*, is fundamental to the fiscal plan.
- An analytic capacity must be developed so that the impacts of fiscally-driven decisions can be determined. In particular, develop the necessary information systems and staffing capacity to monitor and project wage bill pressures and produce salary simulations that will assist with collective bargaining and compensation policy.
- Assign decision-making responsibility for major restructuring decisions and their linkages to the fiscal plan to the inner cabinet; assign leadership for government restructuring to an organization at the center of government.
- Develop a medium-term restructuring plan that targets priority areas (e.g., judicial reform; economic policy functions), rather than launching a massive cross-government functional review exercise.
- Propose an amalgamation of economic ministries and a refocusing of ministry mandates to address the demands of developing a market economy and European integration (e.g., regional economic development, investment planning, new regulatory regimes).
- Assign leadership and create a multi-ministry working group to develop the next generation of compensation policy reforms: formulation of contingency salary containment scenarios that can be quickly implemented to arrest unanticipated wage bill escalation; comparison of occupational mix and practices across institutions in assigning job complexity coefficients (targeting those organizations with the highest average salaries); evaluation of the impact of the new salary policy on turnover in various organizations, age groups, and occupations with a view to modifying compensation policy to encourage recruitment and retention for in-demand occupations; development of a medium-term plan to implement a uniform compensation system across the civil service; recommendations to reintroduce incentive pay, e.g., reducing the percentage of annual increase provided for years of service.

## B. MODERNIZING CROATIA'S CIVIL SERVICE

4.29 After consolidating itself as an independent nation in 1991, a state administration was established. During the 1990s, little progress was made in breaking from the nomenclature system towards a modern civil service capable of facilitating Croatia's democratization process and its transition to a market economy. The only significant restructuring occurred at the local level with the massive expansion in the number of sub-

national governments from 104 to over 560. At the present time, the Government faces the combined challenge of structural reform and preparing for European integration with a civil service organization and management regime little changed from the early 1990s.<sup>62</sup>

4.30 While the Government is aware of the importance of civil service reform, concrete actions are thinly spread and a coherent short- and medium-term action plan is still lacking. This section discusses some of the key priorities which a comprehensive government plan should address. Such a plan need not be comprehensive; it must, however, deal with the critical policy and capacity gaps identified below and provide an affordable, practical route forward.<sup>63</sup>

### **Government Initiatives**

4.31 The scope of necessary change is outlined in the draft development strategy for public administration, prepared for the Government in conjunction with the *Croatia in the 21<sup>st</sup> Century* exercise.<sup>64</sup> This assessment describes a civil service where: political intervention and vested interests in the status quo impede strategic reforms; too many positions are filled on the basis of political affiliation or nepotism; a chronic inability exists to implement policy directions; and training and development of civil servants are for the most part ignored.

4.32 Against this backdrop, the Government has undertaken a number of steps to energize the reform process. The government program signaled the need to reign in costs, streamline and modernize the civil service, develop a competitive compensation policy, and strengthen local self-government. The 2001 *Law on Civil Servants and Employees* and *Law on Obligations and Rights of State Officials* clearly differentiated between political appointees and civil servants and instituted a more rigid and uniform salary regime as part of an attempt to control spiraling wage bill costs.

4.33 However, the public administration reform strategy paper had not yet been formulated. A proposal committing the Government to several fundamental reforms, such as depoliticization, restructuring, and strengthening central capacity, was prepared by the Government Strategies Office in 2002 but was not approved by the Government. *The Ministry of European Integration was assigned the role of coordinating body in the Fall of 2002 in preparation for a feasibility study for public administration reform which should be discussed by the Government in June 2003.*

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<sup>62</sup> There was some progress in the 1990s. The Government Decree on Principles for Internal Organization of Ministries and State Administration simplified the internal structure of ministries and reduced the managerial staff by about 60 percent.

<sup>63</sup> The Government has recently signaled its intention to tackle civil service reform with the launching of the CARDS 2001 public administration reform project.

<sup>64</sup> Although not approved, the draft strategy has been posted on the Government's website.

## Objectives, Progress and Gaps

4.34 Several hallmarks of a modern, effective civil service are set out below. Croatia's progress in moving towards best practices and EU standards and meeting SIGMA<sup>65</sup> baselines is included in this assessment.

### *Legal Framework*

4.35 **Meeting SIGMA baselines requires that an appropriate legal basis exists defining the status of public servants.** Croatia's Law on Civil Servants and Employees (March 2001) establishes the fundamental legal framework within which civil servants act. It contains provisions with respect to definition of civil servants and employees, conflict of interest, rights and obligations, admission requirements, discipline and penalties, job classification and duties, training and development, performance evaluation, transfers, redeployment, compensation, and termination. A separate Law on Obligations and Rights of State Officials provides the legal framework for political appointees (December 2001). Other legislation applies to the broader public sector, such as teachers, health care workers, and local government employees.

4.36 At a broad level, Croatia's governing legislation meets the majority of criteria set by SIGMA, but does contain gaps with respect to cross-government management, cost factors, secondary legislation, and personnel participation. In general, it was observed that line ministries were implementing the provisions of the Act with the notable exception of training and development where fiscal restraint was cited as the inhibiting factor.<sup>66</sup> It was also suggested that the backlog in administrative procedures far exceeded the legislated deadlines for investigating complaints or appeals launched by civil servants.

### *Political Neutrality and the Merit Principle*

4.37 **SIGMA recommends that public servants be able to act independent of political influence, and that open, merit-based recruitment be the norm.** The change in government in 2000 was not accompanied by politically-driven changes below the levels demarcated for political appointees. The fundamental problem remains the low level within the administration at which the line between political and administration roles is drawn. In addition to deputy ministers, both assistant ministers and ministry secretaries are appointed, as well as all directors of state administrative organizations and the heads of the offices that support the Government. Assistant ministers and ministry secretaries in particular play roles (managing program areas, overseeing internal administration within the ministry) that would be part of the professional civil service in

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<sup>65</sup> SIGMA (Support for Improvement in Governance and Management in Central and Eastern European Countries) was established in 1992 as a joint venture of OECD and EU Phare to assist efforts of CEECs to join the EU.

<sup>66</sup> The Act provides for in-service training to be provided to all civil servants, for a training plan to be agreed to between the civil servant and a senior official, and for funding to be provided in the state budget to deliver this training.

most European jurisdictions. Lithuania recently converted positions equivalent to deputy ministers and assistant ministers from political into merit-based appointments.

### *Central Capacity and Oversight*

4.38 **SIGMA cites the capacity for operating cross-government structures and systems for personnel management as critical to efficient management of public servants.** The civil service legislation confers a variety of authorization and transactional responsibilities on Ministry of Justice Administration and Local Self Government's (MJALSG) department responsible for civil service management. However, the law does not set out any broad authority or assign responsibility to the department to establish government-wide standards, ensure the quality of the line ministry personnel functions, foster mobility and career development, monitor and evaluate ministry performance, and develop benchmarks, policies and programs to modernize the civil service. In addition, the core civil service management office of MJALSG is understaffed and inadequately budgeted.

4.39 Oversight is another gap. No autonomous or semi-autonomous organization exists to serve as an avenue of appeal and to ensure that the law is being applied fairly. The administrative remedies that are available face severe backlogs and delay. In many systems, an arms-length organization often exists (e.g., civil service commission) to safeguard public service neutrality and protect the merit principle. In FYR Macedonia, the recently created Agency for Civil Servants, reporting to Parliament, will play an oversight role.

4.40 There is as well an issue as to whether the Ministry of Justice is the appropriate organization to be leading civil service reform. Given the enormous pressures for judicial reform, and the cross-ministry impact of civil service reform, consideration could be given to moving these responsibilities to a more central ministry or organization. In various CEECs, the initiative is being led by the Ministry of Interior (e.g., Slovenia, Lithuania) or an office reporting to the government, sometimes through its own minister or deputy prime minister (Bulgaria, Latvia).

### *Accountability and Performance*

4.41 **SIGMA baselines require effective accountability mechanisms reinforced and performance being recognized and rewarded.** Like many CEECs, Croatia has not yet developed a results-based system at the governmental level. This is strikingly evident in the budget formulation process where a disconnect exists between policy and fiscal planning and budgets are not linked to results. Lithuania offers a current example of an accountability system where the Government sets priorities within a fiscal plan, concurrently approves and monitors ministry plans, budgets and performance measures, and in the following year assesses and publishes achieved versus expected results. In Croatia, results are usually expressed in terms of meeting deadlines of the Government's annual work plan or SAA commitments.

4.42 Although individual performance agreements are required by law and are routinely completed in ministries using the format established by MJALSG, they do not typically reference government objectives or measure policy outcomes and there are no guidelines to ensure consistency of application between or within ministries. The existence of a functioning individual performance evaluation system offers grounds for optimism that a more results-based system, tied to government and ministry priorities can emerge.

### ***Training and Development***

4.43 **SIGMA recommends that conditions of service and career opportunities ensure that appropriate knowledge and skills are recruited, developed and retained.** Training levels and capacity have eroded over the last decade. No generic training programs exist for civil servants or civil service managers. The Institute of Public Administration ceased operation in the 1990s. No service-wide training plan is prepared or training needs assessment completed. Although MJALSG is responsible for training, its resources in this area are allocated to operating the state exams (approximately 1,000 civil servants attend per year).<sup>67</sup> In fact, the only substantial corporate training that does occur is either provided through technical assistance or through the current program being coordinated by the Ministry of European Integration.

4.44 Given the urgent priority to build administrative capacity, this gap must be addressed as soon as possible. Many CEECs' civil services have created public administration institutes (e.g., Latvia, the Slovak Republic, Slovenia), while others have created organizations that oversee the development of a national training plan (e.g., Hungary).

4.45 There is one particular dimension of training and recruiting which deserves special attention – leadership. Leaders must move beyond the traditional management competencies to emphasize: developing and communicating a personal vision; thinking and acting strategically; challenging assumptions; focusing on results; “outside-in” learning; awareness of the external environment; and building new ways of working (OECD/PUMA 2000). These competencies apply regardless of whether a public service centrally develops its future leaders (e.g., France's ENA) or secures them from the open market (e.g., New Zealand).

4.46 By embarking upon the European integration path, Croatia is committing to far-reaching change in the way its institutions will serve the public interest. Leadership at both political and administrative levels will be required to move this agenda along at an appropriate pace. There are several excellent sources for identifying the necessary leadership competencies for a modern civil service (e.g., United Kingdom, Canada).

### **Key Recommendations**

4.47 The following recommendations set out critical priorities of reform:

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<sup>67</sup> The issue of training of civil servants is now part of the CARDS 2001 program.

- Complete the public consultations on and government review of the draft public administration strategy paper (Croatia in the 21st century).
- Assign political responsibility for reviewing and approving the strategic dimensions of this reform, as well as the related reforms in government restructuring, policy management, and public expenditure management, to the inner cabinet.
- Relocate the public administration reform function from the Ministry of Justice to the center of government. Supplement existing resources with sufficient policy and project resources to undertake the reform. Commit to finding offsetting savings within the existing budget of the Government within one year.
- Approve terms of reference for a civil service reform initiative that will develop a costed, time-bound medium-term implementation plan that will:
  - integrate, at a minimum, all assistant minister, ministry secretary, and equivalent positions into the permanent civil service;
  - promulgate regulations that would explicitly link hiring with merit;
  - develop and cost options on implementing an oversight body;
  - develop and cost options on creating a stronger central human resources management function within the government;
  - adopt a modern set of leadership competencies for senior management;
  - complete a training needs analysis for the civil service and recommend interim and longer-term solutions to deliver the necessary training;
  - link deliberations on strengthening individual accountability and the introduction of results-based management to related reforms in government restructuring, policy management, and budget formulation process;
  - reflect all of the above recommendations on a multi-year basis in the next budget request submitted by the Government.
- Enlist technical assistance to work with the project leadership.
- Explore with the Ministry of Finance the establishment of a civil service registry compatible with the payroll system under consideration, so as to permit the cross-referencing of staffing and salary data.

4.48 Whether or not public administration reform is accorded high priority status, it must be recognized that steady if not accelerated progress must be made in modernizing the civil service as chronic weaknesses in this area undercut the Government's ability to deliver on broader reforms. The European Commission's staff assessment of Croatia's progress indicated that notwithstanding the Government's significant efforts to approximate legislation, "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" (European Commission, 2002).

### **C. STRENGTHENING POLICY MANAGEMENT**

4.49 Croatia faces significant challenges in implementing concurrently the transition and European integration agendas. Although the reforms are, for the most part,

complementary, their scope and complexity threaten to overload the Government's decision-making system. To manage such an agenda requires not only that line ministries have sufficient policy development capacity, but that the center of government operates a reasonably sophisticated policy management system, effectively supported by highly skilled central agencies. This section begins with a description of Croatia's decision-making system and its central agency support. Croatia's system is then assessed against the characteristics of a high quality policy management system, including SIGMA's baselines for policy-making and coordination. Finally, priority areas for future reforms are identified.

### **Decision-Making Structures and Process**

4.50 Croatia's organization of its decision-making structures follows a standard configuration where the Government (Prime Minister, Deputy Prime Ministers, Ministers) serves as the ultimate decision-making body, but is presented with policy proposals that have already been reviewed by a standing committee (referred to in Croatia as a "coordination"), comprising a smaller number of ministers. The committee structure is organized in policy clusters (economic; social; internal/external) and also includes an inner cabinet, chaired by the Prime Minister, to deal with complex or contentious issues.

4.51 The one gap in this system is that there is no clear assignment of responsibility for strategic, horizontal issues such as priority-setting, restructuring, and civil service reform. The inner cabinet would be an appropriate body for such responsibilities. This role would be similar to Lithuania's Strategic Planning Committee which is also chaired by the Prime Minister.

4.52 The review process is set out in the Government's *Rules of Procedure* and requires that ministries/state administration bodies submit signed materials to the Secretary of Government. However, government decision-making is primarily viewed as a transactional process centered on draft legislation. If the draft law affects European integration, an EU compliance statement is requested. Although other documents, such as strategies, may be submitted for approval to the Government, no special procedures for such a review are articulated. The practice of reviewing concept papers prior to initiating legislative drafting (e.g., Latvia) has not been introduced. The *Rules of Procedure* omit any discussion of the Government's role in setting priorities, reviewing the macroeconomic forecast, deliberating on the budget, assessing EU implications, requiring policy, financial or regulatory impact analyses, establishing the legislative program, monitoring progress, or assessing actual versus expected results.

### **Central Agency Support**

4.53 The supporting central agency structures in Croatia are the Achilles heel of the policy management system: for the most part they remain ill-equipped to implement the badly needed reforms. There are two critical central agency functions where important weaknesses have been detected: policy management and budget formulation. There are two other functions, European integration and aid coordination, where, although

significant progress has been achieved, the agenda is being hampered by the problems in the overall policy management, budget formulation systems and civil service constraints. Until a strategic policy capacity is developed and integrated with a multi-year, program-based budgeting process, there will not be a strong policy basis for effective implementation of EU-type legislation and identification of aid priorities.

- **Policy management.** Croatia's configuration is unusually fragmented and would not be conducive either to leading policy management reform or delivering stronger strategic and analytic functions. Policy management is in charge of separate departments or units which include the government secretariat, the government legislative office, four policy advisors to the Prime Minister, individual cabinets for the four Deputy Prime Ministers, and the newly created Strategies Office.<sup>68</sup> All senior positions fall into the political appointee category. The creation of a Strategies Office suggests that a more proactive strategic and analytic role is being contemplated, but this has not yet been realized in practice. In Lithuania and Latvia, the individual offices that support the Government's decision-making process, with the exception of individual political advisers, report through the head of the Chancellery/General Secretariat.
- **Budget formulation.** The need to strengthen the Ministry of Finance's budget functions was highlighted in the PEIR of 2002. Severe understaffing exists in macro forecasting, budget preparation and debt management. High turnover (e.g., at the end of June 2002, all analysts had left the macro forecasting department) presents a further problem. The ministry structure is unwieldy; despite the clustering of four functions under the Treasurer, there remain 13 direct reports to the Deputy Minister and the highest number of assistant ministers in the Government. The success of process improvements, program budgeting, strategic planning and impact assessment will depend heavily on the Ministry of Finance strengthening its analytical capacities and assuming a proactive role to contest assumptions, identify alternatives, gauge impacts and evaluate results.
- **European integration.** The Ministry of European Integration was established in February 2000. For 2001, a staffing level of 125 employees was approved. The Ministry is structured into a secretariat general and directorates of law harmonization, strategy, EU aid coordination, and information, education and translation. The Ministry has successfully asserted itself into the center of government planning. It oversees the preparation of the SAA implementation plan, including legal approximation through to 2006, and coordinates these with the preparation of the Government's annual work plan. Quarterly and monthly monitoring

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<sup>68</sup> The Strategies Office was created in 2000, reports to a Deputy Prime Minister, and comprises a director and seven analysts. Their primary task is to coordinate and oversee the preparation and approval of the 19 strategies under the Croatia in the 21<sup>st</sup> Century exercise. The office has also prepared several individual policy papers.

status reports are prepared. Attempts are being made to better link EU and budget planning and develop measures that reflect the quality of implementation. In addition, the Ministry provides one of the only training programs for civil servants. The Ministry's core functions appear to be adequately resourced and are in line with similar organizations in other CEECs. Overall, the Ministry appears to be building a solid foundation for playing a proactive role in furthering the European integration process, although it has been hurt by turnover.

- **Aid coordination.** This responsibility is not assigned to one area, although the Ministry of European Integration plays the most prominent role. Several decisions were taken in October 2001 to ensure more effective coordination of technical and financial assistance from IFIs and donors: the Minister of European Integration was appointed national coordinator for EU assistance; a permanent working group was established to coordinate aid and ensure that it supports sectoral priorities; all state administration bodies in receipt of CARDS<sup>69</sup> assistance must establish project implementation units. Although these initiatives are positive, they have yet to be fully implemented and it is generally perceived that aid coordination remains problematic.

### **Policy Management Capacity**

4.54 The following explores several attributes of a high quality policy management system and vis-à-vis those benchmarks assesses how they are practiced in Croatia.

#### ***Policy Consultation and Coordination***

4.55 All countries struggle with horizontal policy management. Two critical success factors include effective consultation and coordination. These relate both to the strategic and transactional levels. The latter essentially involves ensuring that all those who should have a say in a particular policy are provided with a meaningful opportunity. Although policy development is increasingly recognized as having multi-ministry implications, most policy is still developed by a single line ministry. To ensure the quality of that policy, external and internal consultation are encouraged and sometimes mandated.

4.56 The Croatian Government has demonstrated a willingness to consult externally. NGOs, academia, labor and business are routinely contacted or even engaged in the policy process. With respect to internal consultation, a requirement in the Government's *Rules of Procedure*, it is usually pro forma rather than substantive.

4.57 In terms of policy coordination at the political level, until the inner cabinet or some equivalent structure is empowered to assume a more strategic role, the effectiveness of coordinating mechanisms will be limited. At the administrative level, there is an increasing tendency to create multi-ministry working groups to draft legislation. The rush

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<sup>69</sup> The CARDS program (2000-2006) replaces Phare and Obnova as a vehicle of financial and technical assistance to Balkan countries (excluding Slovenia).

to develop new coordinating mechanisms—Croatia has not instituted yet some of the formal inter-ministry coordinating mechanisms that have been used productively in other countries such as a ministry secretaries’ council—should be tempered by the need to ensure that those in place are functioning well.

### *Strategic Capacity*

4.58 A UNDP study identified more than 100 strategies, the vast majority of which were never carried through to implementation (UNDP 2001). One of the most ambitious strategic forays, Croatia in the 21<sup>st</sup> Century, was initiated in 2000 and mandated the development of individual strategies in 19 subject areas.<sup>70</sup> Although a small number of the strategies have been adopted<sup>71</sup> it is too early to assess the impact of this venture. The exercise should certainly be lauded as a serious attempt to create a strategic policy framework.

4.59 However, neither the strategies themselves, nor any other critical statement of government policy including the government program, have been converted into practical, affordable medium-term plans or placed within a fiscal framework. These problems directly relate to deficiencies in the budget formulation process (see Croatia PEIR 2002; IMF 2002). One key concern is that the strategies reinforce the highly sectoral (ministerial) approach that dominates policy development. Of the 19 strategies, 15 fall within traditional ministry or sectoral mandates.<sup>72</sup> As a result, complex yet compelling horizontal issues such as poverty reduction, decentralization, demographic challenges, or regional development remain unaddressed. It is also interesting to note that perhaps the most cross-cutting subject, economy, is being prepared by the smallest team (six members vs. 30 for health care and 37 for transportation). Lithuania adopted a cross-cutting strategic planning system that interacts with budgetary reform.<sup>73</sup>

### *Analytic Capacity*

4.60 The dominant form of analysis undertaken is legal. Both the Government Legislative Office and the Ministry of European Integration’s legal approximation directorate review ministry drafts from the perspective of constitutionality, legality, quality and EU compliance. Increasingly, the importance of looking beyond the law itself

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<sup>70</sup> Each strategy has been led by an expert supported by a team (often including ministry officials) that was expressly permitted to develop the strategy free from government policy oversight. The Government Strategies Office plays a coordinating and quality assurance role. Following completion, the strategy is reviewed and where necessary negotiated with the responsible ministry before proceeding to public consultation. The strategy is then tabled for review by the Government and ultimately approved by Parliament.

<sup>71</sup> Thus far the following strategies have been adopted: environment; information and communication technology; culture security and defense; energy; science; macroeconomy, agriculture and fisheries; and development principles of Croatia.

<sup>72</sup> Sectoral strategies include: health care; social care and pensions; transportation; power supply; national security; macroeconomics; education; science; tourism; culture; environmental protection; maritime affairs; shipbuilding; food production; housing construction. Horizontal strategies include: state administration; international integration; economy; information and communication technology.

<sup>73</sup> See “Building a Modern Public Administration” (G. Evans 2002), Box 3 for a description.

into the impacts of its application is being acknowledged. To ascertain policy or regulatory impacts requires a much more rigorous policy development process. Beyond the determination of standards and protocols, the introduction of stronger policy analysis and impact assessment will require training or in some cases the creation of policy departments and hiring of policy staff. In related areas, such as Finance, budget staff will need to be trained in going beyond the purely financial implications of a ministry proposal.

4.61 Reinforcing the analytic gap is the poor quality of data. Although individual organizations (e.g., Croatian Employment Service) are taking steps to improve information management, the central data sources are very poor. Central human resources data is virtually non-existent. Although the current initiative by the Ministry of Finance to develop budgets by programs is positive in this regard, the rudimentary state of financial data (no central payroll system exists that can link salary to individuals) will continue to hamper progress in improving budget management. The postponement of 2002 negotiations with the IMF as a result of data deficiencies served to underscore the gravity of this problem.

### ***Policy Continuity***

4.62 Complex policy reforms can only be implemented in the medium to longer term. Four to five years are often required to build consensus on the best policy option, articulate detailed policy directions, prepare draft primary and secondary legislation, receive Parliamentary approval, identify budgetary requirements, hire staff, and operationalize a new or revamped program. To accomplish this expeditiously and effectively requires that the policy development process proceed without significant disruption. Discontinuity will be most prevalent in systems with high levels of political and/or administrative instability.

4.63 Although tenure in Croatia's governments have thus far lasted longer than most CEECs, increased political instability in the future is certainly possible given the fragmented political scene with no single party able to form a majority in Parliament and given that many parties do not have a clear political profile. Where high levels of political instability exist, policy continuity will depend heavily on administrative stability serving as a counterweight. With political appointees reaching deep into the administration (down to the ministry secretary and assistant minister levels), changes in government can be accompanied by turnover of those officials who have content responsibility for policy development. The capacity and knowledge gap between assistant ministers and the next subordinate level can be considerable. The *Croatia in the 21<sup>st</sup> Century* project is just one example where an ambitious policy undertaking that is at a very early stage of completion has been placed in limbo by political instability.

### ***Reliability***

4.64 Most of the weaknesses in the factors of policy management described above lead to a lack of policy reliability. High levels of policy unreliability, in turn, affect investor sentiment and public service performance. Based primarily on interviews, major problem

areas include the practice of establishing political commitments outside a fiscal framework, the lack of priority-setting to guide the budget formulation process, the persistence of single-year incremental budgeting,<sup>74</sup> and the absence of results-based planning and accountability mechanisms. Measuring Croatia's current policy management capacity against SIGMA's baselines for policy-making and coordination,<sup>75</sup> while problems with the budget formulation process are again in evidence, issues regarding resourcing of key functions and administrative capacity of central agencies are also highlighted as areas that need to be strengthened. Comparisons with 10 other CEECs using a range of governance indicators developed by the World Bank indicate that the perceived performance of Croatia's public sector, with the exception of the very poorly perceived judiciary, ranks in the mid- range.<sup>76</sup>

### ***Policy Management – Recommendations***

4.65 Croatia needs to initiate a policy management reform process. To be successful, it will have to interact and mutually reinforce the objectives set for budget reform and/or civil service reform. A strategy to improve policy management systems should:

- Extend the mandate of the inner cabinet coordination body (chaired by the Prime Minister) to encompass strategic planning, policy management, budget, and civil service reform.<sup>77</sup>
- Initiate an organizational review of the government offices and Ministry of Finance with a view to both organizations playing a proactive and mutually reinforcing role in priority-setting, integrating fiscal and policy planning, impact analysis, contesting ministry proposals, and monitoring and evaluating results. Create a consolidated Government Office that will include all areas with the exception of advisers to the Prime Minister and Deputy Prime Ministers.
- In parallel with the depoliticization process across government, convert all positions in the government offices, with the exception of advisers to the Prime Minister and Deputy Prime Ministers, into non-political positions.
- Initiate an organizational review of the support provided to Parliamentary committees to determine the best way of improving the quality of analytic and research support.
- Identify and provide additional resource requirements (with offsets from elsewhere in the Ministry) in critical areas of the Ministry of Finance (e.g.,

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<sup>74</sup> A new organic Budget Law adopted in December 2002 requires that each future annual budget include a three-year budgetary framework, regular publication of associated fiscal data, and assigns penalties to overspending budget units.

<sup>75</sup> See Tables 12 and 13 in G. Evans (2002), op.cit. for details.

<sup>76</sup> G. Evans (2002), op.cit. See Table 14.

<sup>77</sup> Care must be taken that only high-level, critical issues in civil service reform are brought to this committee. Other decision-making venues should review the more administrative proposals. Otherwise, excessive demands on the Prime Minister's time will result and the ability of the committee to focus on strategic issues will be diminished.

budget analysis, macroeconomic forecasting, debt management, financial information systems).

- Mandate one office or unit, working with the Ministry of Finance, to develop a methodology for creating medium-term implementation plans for approved strategies. This must be integrated with the budget formulation process.
- In conjunction with introducing priority setting as a component of budget reform, ensure that an aid coordination strategy is developed that reinforces these priorities.
- Pilot the use of concept papers as a precondition of initiating legislative drafting for complex policy proposals.
- Pilot the preparation of financial and policy impact assessments (following standard templates – rudimentary at first) to accompany major policy proposals. Initiate the identification of results measures as part of this exercise.
- Regularly report (at least quarterly) to the Government on progress being made towards the fiscal plan and the achievement of policy priorities -- SAA reporting undertaken by the Ministry of European Integration could be built on as a model.
- Secure appropriate technical assistance for these reforms.

#### **D. REGIONAL AND LOCAL SELF GOVERNMENT**

4.66 This Report does not address the complex policy and fiscal issues relating to the reform of regional and local self-government or recommend a particular model or reform path. Rather, this section of the Report explores the degree to which the current or proposed structure and capacity of regional and local government in Croatia are up to the task of completing the transition and facilitating European integration.<sup>78</sup> It will be contended that the significant capacity gaps identified in the previous section on civil service reform apply equally or more at sub-national levels.

##### **Administrative-Territorial Organization of Croatia**

4.67 Croatia's organization of regional and local government is characterized by the high number of sub-national entities and the low degree of delegation from the state level. The sub-national level comprises the City of Zagreb, 20 counties, 123 towns and 424 municipalities.<sup>79</sup> The majority of municipalities have populations below 3,000. High-volume/low population configurations place significant pressure on municipalities to create consortiums for delivering common services. In Croatia, for instance, seven local self-government units in the Island of Krk have pooled resources for water and waste

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<sup>78</sup> This section draws heavily on the comprehensive work on local government in Croatia completed by the Urban Institute for USAID.

<sup>79</sup> The number of local government units was increased to current levels in 1997 from the 104 that existed at independence. In 2001, legislative changes designated counties as units of "regional self-government" while towns and municipalities as units of "local self-government."

treatment. This also poses a significant challenge regarding the recruitment of skilled personnel capable of negotiating, managing, and monitoring such agreements.

4.68 Although the list of powers administered by sub-national governments is not dissimilar to those in Western European countries, the implementation of and funding for these powers suggest that Croatia remains highly centralized. Croatia's expenditure of 12.4 percent of the consolidated general government budget (1999) is well below the OECD average of 29 percent of the CGG budget and is at the low end of the Council of Europe members' range from 4.1 to 60 percent (Urban Institute 2001).

4.69 Although the gradual pace of reform is likely prudent, the failure to identify any policy parameters to guide the development of a medium-term strategy is hampering efforts to put the basic building blocks in place. Admittedly, amalgamation is a highly contentious political issue, but some concrete decision one way or the other will permit other reforms to advance with greater certainty. In either case, a significant effort must be made to forge partnerships among clusters of municipalities. France, for example, has extensive experience with such arrangements.

### **Regional and Local Self-Government Reform**

4.70 Although the Government has endorsed some broad policy objectives in advancing regional and local self-government, concrete progress has, not surprisingly, been slow. Such reforms unfold over the longer term and typically involve numerous ministries and significant transfers of financial and human resources. The *Program of the Government of Croatia* identified an excessive number of self-government units and over-centralization of functions as an impediment to effective governance at the local level. Further, it committed to "a process of extensive decentralization", including legislating the principle of subsidiarity and amalgamating county and local governments.<sup>80</sup> Constitutional amendments in 2000 paved the way for expanding the scope of local self-government and introduced the concept of regional self-government (Articles 128-131). In April 2001, Parliament approved a new *Law on Local and Regional Self-Government*. The accompanying changes institute some gradual steps towards decentralization including the transfer of certain management and administration functions for schools, health institutions, traffic management, urban planning and social protection centers to the county level (and select towns) along with additional financing.

4.71 Significant policy ventures are underway but had not as of July 2002 reached the government review stage of the policy process. The *Development Strategy of the Republic of Croatia: Public Administration*, part of *Croatia in the 21<sup>st</sup> Century*, includes a section on local self-government. It calls for strengthened local powers and amalgamation, but does not offer a firm plan as to how to achieve these objectives. A three-year study, "Decentralization of Public Administration," was agreed to in

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<sup>80</sup> The Maastricht Treaty declared the principle of subsidiarity to be fundamental. This principle implies that public authorities do not take actions that can be done adequately and effectively by citizens and whereby the higher levels of member states, following the principle of gradation, act only when lower levels cannot do so satisfactorily.

November 2000 between the Government and the Open Societies Institute through the Croatian Law Center.<sup>81</sup> And USAID is working on fiscal decentralization and broader local government reform through the Urban Institute. The problem of these projects is the lack of direction from the Government on the key issues of amalgamation or the envisaged scope of decentralization.

### **Capacity Gaps**

4.72 Like central government, regional and local governments suffer from significant capacity gaps in the areas of policy management and civil service reform. Specific weaknesses include over-politicization and lack of training and development. The politicization issue is acute at local levels where political pressure for highly-prized administrative jobs is significant. Currently, a number of senior jobs below the prefect/mayor level are dependent on election by the applicable assembly. Parallel measures should be taken to raise the demarcation line between political appointees and professional civil servants at both the national and sub-national levels and to ensure a merit-based hiring process

4.73 At the local level, little formal training is available for civil servants, although some has been provided through technical assistance programs. Given plans to move more functions to the local level, pressures to develop service sharing agreements, and the prevailing recruitment challenges outside large cities where qualified candidates are in short supply, basic skills training will be critical to ensure that the service quality objectives of decentralization are not compromised because of capacity issues. The Association of Cities and Municipalities (ACM) is a logical partner in training ventures and will, itself, need to strengthen its policy analysis capabilities. In some countries (e.g., the Czech Republic), a local government training institute exists to oversee this process.

4.74 In the central government, the department responsible for local self-government operates in MLASG and is neither adequately staffed nor empowered and comprises an assistant minister, two unit heads, and three policy assistants. The decision on relocating the civil service management function for central government should also apply to the local self-government function. Restructuring cannot be meaningfully undertaken without a plan concerning the functions that will eventually devolve to the regional and local levels.

4.75 The Government's policy management system was seen to suffer from a lack of policy analysis (no financial, policy, or regulatory impact assessments are prepared). When impact assessment is introduced government-wide, a thorough assessment of impacts on sub-national levels of government should be among the analytic requirements. Consultation with the ACM could be made mandatory.

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<sup>81</sup> Individual reports will be produced on the electoral system (completed), territorial organization, regional/local financing, legal status and powers of local self-government, status of local officials, and the decentralization of primary education, secondary education, health care, social services, and culture.

4.76 No one organization, or coordinating mechanism exists to ensure that coherent regional development policy is developed. Technical assistance is being provided in this area but donors are uncertain of how an overall approach will be coordinated. This is particularly problematic in the area of municipal infrastructure, where efforts need to be integrated with broader economic and investment planning. Stringent EU environmental standards will further place pressure on the Government to develop a policy capacity at the regional level.<sup>82</sup>

### **Recommendations**

4.77 The following recommendations are limited to public administration reform and policy coordination issues which, if not addressed, will adversely affect decentralization and strengthening of local self-government.

- Raising the demarcation line separating political appointees and civil servants.
- Relocate the MJALSG working on local self-government to the same organization as its sister organization working on civil service reform in the central government.
- Establish a working body with strong regional and local government participation to develop options, impacts, and implementation plans for decentralization. Include in this group's mandate the task of developing strategies to facilitate shared services agreements among local governments.
- Incorporate decentralization and local self-government as an integral component of the terms of reference for government restructuring and civil service reform.
- Ensure that any initiatives to strengthen national investment planning are closely coordinated with efforts to improve municipal infrastructure. Require policy and financial impact assessments to reflect impacts on sub-national levels of government.
- Coordinate closely (or integrate) the needs assessment and strategy development for delivering training and development at regional and local levels with similar work to be undertaken at the central government level.
- In conjunction with efforts to restructure the economic policy functions and structures of government, ensure that a clear mandate and organizational presence is created for regional development policy.
- Mandate consultation requirement with ACM for local self-government issues.
- Finalize a position on amalgamation of local self-government units.

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<sup>82</sup> Although the EU environmental requirements do not specify which level of government is most suitable for delivery of specific functions, there are certain functions that typically would be delivered by a regional (water basin management) or local (petrol station inspections) government (Ecotec 2001). Croatia's *Law on Local and Regional Self-Government* assigns environmental protection to the local level.

## E. SEQUENCING AND PRIORITIZING PUBLIC ADMINISTRATION REFORM

4.78 The scope of public administration reform is staggering and can easily overload governments if not managed carefully and sequenced correctly. The dilemma is that the various components of reform—civil service management, decentralization, restructuring, public expenditure management, policy management, etc.—closely interrelate, but it is not feasible to make significant and concurrent strides in all areas without affecting progress in other priority areas, such as economic development. An optimum sequence will need to be established by those charged with crafting the strategy.

4.79 The following recommendations do not pretend to substitute for a strategy but rather conform a minimum common denominator that would have to be achieved, regardless of the strategy adopted, in the near and medium terms. Basic systems and capacities must be prioritized before any of the more sophisticated analytic tools or new public management methods are contemplated. For example, complex new organizational or accountability models should only be looked at in the longer term. When the actual strategy is designed, efforts should be made to identify early, high profile wins. For instance, the judiciary is widely perceived as ineffective in Croatia and would accordingly provide a suitable priority for reform.

4.80 It is difficult to establish a strict prioritization of the reforms as the sequencing to some degree will depend on where a champion appears and the degree to which the Government views overall reform as a national priority. Nonetheless, obvious critical success factors will include sustained political leadership, the development of an affordable, feasible overall plan with clear priorities, and the securing and coordination of appropriate technical assistance. At a minimum, five reform priorities should include;<sup>83</sup>

- **Depoliticize the senior civil service.** The development and implementation of sectoral policy reforms are poorly served if the key management positions directly responsible for it remain political appointees and therefore subject to removal with each change of government. A fair process, with appropriate non-political oversight, should be established and undertaken to initiate competitions for these positions.
- **Accelerate budget reform.** Complex policy reforms and government restructuring, both urgently required in Croatia, cannot be effectively undertaken under a traditional incremental budgeting system. Integration of policy planning with the budget process is further required to ensure that the Government has the means to deliver its policy priorities and that sufficient savings are found to offset the additional expenditures required for their delivery.
- **Strengthen central agency capacity.** Capacity problems within central agencies will impede policy reforms as the quality of the Government's policy management system to a significant degree depends on the

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<sup>83</sup> See G. Evans (2002), op. cit., Table 14 for more specific details on sequencing reforms..

effectiveness of its central agencies. In particular, the weaknesses and under-resourcing in key areas within the Ministry of Finance need to be remedied on a priority basis. Currently, there is insufficient capacity to implement budget reforms identified in *Croatia PEIR 2002, IMF 2002*.

- **Initiate restructuring process.** Croatia has fallen behind many other CEECs in this regard and will need to initiate a restructuring process if it is to adapt its institutions to EU norms. The importance of restructuring the delivery of economic policy, including regional development has to be emphasized. The current mix of ministries/agencies and gaps in mandates produces policy fragmentation rather than coherence. Although judicial reform was not analyzed in this Report, it was clear from government, donor, and civil society assessments that this should constitute another priority reform area. Finally, an often overlooked but essential contributor to successful restructuring is quality data.
- **Develop decentralization strategy.** It is important to emphasize that this priority does not suggest rushing implementation. There are major fiscal, accountability, and capacity issues that will accompany this process. What is required urgently is the completion and approval of a policy strategy informed by detailed policy and fiscal options so that the implementation of decentralization can proceed in a coherent, affordable manner. Being so central to the design of an overall decentralization strategy, it would be useful if a position on amalgamation could be finalized.

## **5. STRENGTHENING THE LEGAL AND REGULATORY FRAMEWORK FOR ENTERPRISE RESTRUCTURING, FINANCE AND INVESTMENT**

5.1 At the root of fast and sustainable output and employment growth is the creation of an investment climate and finance environment that can at once encourage enterprise restructuring, investment and job growth. This is crucial to enhance Croatia's capacity to compete in the free trade area emerging across much of Europe and effectively integrate into European structures. As noted already in Chapter 2, improving the investment climate is one of the key elements of the SAA.

5.2 A favorable business environment and investment climate require:

- (a) tax and incentives regimes which are transparent, stable and competitive;
- (b) a solvent and liquid banking system;
- (c) a flexible labor market with the supply side offering a labor force which has the education, skills attitudes and mobility necessary to support businesses which are internationally competitive;
- (d) energy supply, transportation, communication and other infrastructure which is internationally competitive in terms of quality and cost;
- (e) a large domestic market or good trade links with the world;
- (f) property rights can be readily established and protected;
- (g) creditors' rights can be readily established and contracts can be enforced;
- (h) minority shareholders' rights are protected and there is a functioning market for corporate control;
- (i) investors and lenders have access to full and transparent company financial information;
- (j) new businesses, including those with foreign owners, can be readily created;
- (k) failing businesses can be quickly wound-up with their assets distributed among creditors and re-deployed to more productive uses; and
- (l) market competition governs the trade in most goods and the provision of most services and markets are protected from anti-competitive behavior; (all firms operate on a level playing field, regardless of size or ownership).

5.3 This chapter will focus on requirements (b) and (f) to (l); for that purpose it first reviews developments in enterprise restructuring and in the financial sector. Requirements (a) and (e) have been dealt with in previous chapters and requirements (c) and (d) will be dealt with in subsequent chapters. While freedom from corruption could be included in this list, experience elsewhere has also shown that corruption is much less

likely to remain a significant issue once the other characteristics of a favorable investment climate have been obtained.

5.4 In view of the regional integration challenge, Croatia will need to create conditions to attract FDI and accelerate the privatization and restructuring of its enterprise sector. This will require a far more efficient financial sector that can mobilize resources to expanding firms/sectors. The severe constraints which currently hamper enterprise and financial sector development have a common denominator: the legal and regulatory framework and the institutional capacity to implement it. This is the subject matter of this chapter.

5.5 The chapter first reviews enterprise restructuring and privatization (Section A) and describes reforms and performance of both the bank and non-bank financial sector (Section B). The key legal, regulatory and institutional barriers to enterprise and financial development in Croatia are reviewed and a strategy to reform the legal and institutional framework is proposed (Section C). The chapter then focuses on specific financial regulatory issues and policies conducive to enhance financial stability (Section D) and concludes with some recommendations for improving the privatization strategy (Section E).

#### **A. ENTERPRISE RESTRUCTURING AND PRIVATIZATION**

5.6 Since the outbreak of hostilities that followed independence, Croatia's enterprise sector has been evolving towards a private and more competitive sector. However, the privatization process is far from complete and progress in restructuring while uneven has been overall disappointing. This can be ascribed partly to inefficient labor and financial markets and in part to the privatization strategy and, more important, the failures of the legal and institutional framework. To illustrate what restructuring and privatization has achieved so far and what it has not, this section reviews enterprise's performance. The analysis below is based on comprehensive financial, employment and ownership data for the enterprise sector provided by FINA for 1996-2000.<sup>84</sup>

5.7 The first stage of privatization in 1991-96 was characterized by sales to insiders (employees, managers) with large discounts and five-year installment schemes; when difficulties for repayment arose, the Government prolonged the repayment period mostly softening the terms. A flawed tender sale program in the early 1990s led to the emergence of large "tycoon groups" similar to those which resulted from privatization in the Czech Republic and the Slovak Republic, with the same results, including asset stripping and the use of firms as vehicles for extracting loans from banks which were subsequently diverted for the benefit of the owners of the firms. As shown in Table 5.1, by 1996, 2,361 of an original universe of around 3,600 state and socially owned enterprises in 1991 had been privatized with cumulative revenue from privatization totaling a mere 1.4 percent of GDP.

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<sup>84</sup> This data shows the structure of enterprise ownership, recent trends in enterprise privatization, the enterprise sector's contribution to the economy and the creation of employment, trends in wages and productivity, and the financial performance and financial structure of the enterprise sector.

5.8 The high incidence of loss-making among SOEs (56 percent) and privatized enterprises (39 percent) in 2000 suggests that restructuring in these firms to date has been largely insufficient. Between 1996 and 2000, the share of loss-making firms grew in all types of firms but particularly in the large segment of private firms and in the SOEs' segment. The persistent high incidence of loss-making by SOEs and former SOEs also provides an indirect measure of limited restructuring.

**Table 5.1: Ownership Status of Croatian Enterprises from Selected Sub-sectors, 1996 - 2000<sup>85</sup>**

<b>Ownership Category</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
State-owned <sup>86</sup>					
- profitable	590	595	502	517	482
- loss-making	657	605	645	642	622
- total	1,247	1,200	1,147	1,159	1,104
Privatized <sup>87</sup>					
- profitable	1,454	1,450	1,231	1,223	1,176
- loss-making	907	839	875	939	749
- total	2,361	2,289	2,106	2,162	1,925
Private <sup>88</sup>					
- profitable	44,399	43,935	39,422	36,663	36,539
- loss-making	12,605	11,991	15,805	13,841	15,454
- total	57,004	55,926	55,227	50,504	51,993
<b>Total</b>	<b>60,612</b>	<b>59,415</b>	<b>58,480</b>	<b>53,825</b>	<b>55,022</b>

Source: FINA.

5.9 The collapse of the private domestic bank sector in 1998 forced out of their business many tycoon group firms. However, in the remainder of the enterprise sector little or no restructuring took place. Debts carved out of the large banks in the course of rehabilitation were "parked" in the Bank Rehabilitation Agency where no attempt was made to use debt leverage to force firms to restructure. As a result, large numbers of state-controlled firms now have to be restructured and privatized at a very late stage in

<sup>85</sup> The data covers all formal sector businesses that have been registered as enterprises in the following sub-sectors: A. agriculture, B. hunting and forestry; fishing; C. mining and quarrying; D. manufacturing; E. electricity, gas and water supply; F. construction; G. wholesale and retail trade; repair, etc.; H. hotels and restaurants; I. transport, storage and communication; and K. real estate, renting and business activities. Excluded are individuals engaged in crafts and enterprises in the following sub-sectors: J. financial intermediation; L. public administration and defense, compulsory social security; M. Education; N. health and social work; O. other community, social and personal service activities; P. private households with employed persons; and Q. extra-territorial organizations and bodies. The time series does not represent a fixed panel as the ownership and profitability of individual enterprises may change from one category to another from one year to the next.

<sup>86</sup> Includes all enterprises with majority state ownership including public service enterprises such as utilities, enterprises that are being transformed from socially-owned enterprises into limited liability companies or joint stock companies so that they can be privatized, untransformed enterprises and transformed enterprises with majority state participation.

<sup>87</sup> Includes formerly socially-owned enterprises which were transformed and now have majority private ownership.

<sup>88</sup> Includes all enterprises that were founded as private enterprises.

the transition process. During the last 10 years, most of these enterprises have neglected to invest new technology, preferring instead to use cash to maintain excessive levels of employment (redundant workers typically represented over 30 percent of the payroll of socially owned enterprises).

5.10 The statistics in the table suggest that structural reform in the area of privatization was largely stalled or being reversed. In fact, privatization was proceeding, but at a slower rate than the rate at which enterprises were reverting to the State-ownership as their employee-shareholders failed to make the installment payments required under their share purchases agreements with the Croatian Privatization Fund (CPF). In most cases, the defaulting employees were probably making rational decisions to cut their losses as the CPF subsequently sent many of the re-possessed enterprises to bankruptcy (normally any investment by shareholders is lost when an enterprise goes through bankruptcy). As of May 2002, CPF had filed for the bankruptcy of 430 of the enterprises in its portfolio. Reversion to state-ownership remains a serious risk - CPF has outstanding share purchase contracts with 96,000 employee shareholders many of which may still decide to default on their payments.

5.11 The limited effectiveness of privatization during the 1990s implies that Croatia, in spite of having a fast growing private sector (not originated in privatizations), has still one of the lowest private sector shares in GDP - 60 percent in mid 2000. Out of a list of 12 selected transition countries,<sup>89</sup> only Slovenia and FYR Macedonia had a lower share, each with 55 percent. Hungary and the Czech Republic had 80 percent, Estonia and the Slovak Republic had 75 percent and Poland, Lithuania and Bulgaria each had 70 percent.

5.12 Growth in value added by the enterprise sector (Table 5.2) was 12 percent in 1997, minus 1.9 percent in 1998, 8.2 percent in 1999 and 5.1 percent in 2000 - its share in GDP rose from 41.2 percent to 46 percent. Such increase is entirely explained by the emerging private SME segment of the enterprise sector, whose share in GDP almost doubled during the period. Instead, the share of value-added growth by SOEs and privatized enterprises has been shrinking providing further (indirect) evidence of their failure or inability to restructure. In 2000, private enterprises accounted for 71 percent of value added, even though they owned only 57 percent of the assets in the sector. Growth in value added and employment by private enterprises was accompanied by a pronounced increase in the importance of the sub-sectors providing services relative to those providing goods.

5.13 The dominant trends in employment and productivity show that by far the most dynamic sector has been the private (non-privatized) sector. In 1996, the enterprise sector employed over 728,000 persons (out of a total population of 4.5 million) of which 61 percent worked in either private or privatized firms. Although employment declined moderately over the period, the private sector share grew to account for 71 percent of total employment in 2000 (private firms excluding privatized firms account for 41

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<sup>89</sup> EBRD Transition Report (2000). The countries are: Hungary, Czech Republic, Estonia, Slovak Republic, Poland, Slovenia, Croatia, Lithuania, Latvia, Bulgaria, FYR Macedonia and Romania.

percent of employment). Changes in the employment structure, however, were explained by a 27 percent reduction in SOEs' employment, a 14 percent decline in employment by privatized enterprises and a 50 percent increase in employment by private companies. Private enterprises are, on the average, very small but have been growing from an average of 3.4 employees in 1996 to 5.6 in 2000, an increase of 64 percent. Despite having shed off substantial labor, loss-making SOEs and privatized enterprises still employ roughly 200,000 jobs; this is clearly a matter of concern and underlines the need to accelerate the creation of new private enterprises and the restructuring of existing enterprises.

**Table 5.2: Enterprise Sector Value-added, 1996 – 2000 ( % of GDP)**

<b>Ownership Category</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
State-owned					
- profitable	9.64	12.60	11.27	9.26	6.50
- loss-making	5.56	2.68	2.78	4.56	6.95
- total	15.20	15.28	14.06	13.82	13.46
Privatized					
- profitable	13.87	14.25	12.20	12.40	12.71
- loss-making	3.05	2.76	3.18	3.01	2.11
- total	16.92	17.01	15.38	15.42	14.82
Private					
- profitable	8.90	10.89	11.26	14.73	16.06
- loss-making	0.24	0.26	0.86	1.34	1.62
- total	9.13	11.14	12.12	16.07	17.68
<b>Total</b>	<b>41.26</b>	<b>43.44</b>	<b>41.56</b>	<b>45.31</b>	<b>45.95</b>

*Source:* FINA.

5.14 The enterprise sector increased its labor productivity by 28 percent during the 1996-2000 period (Table 5.3). The largest increase, 46 percent, was produced by private SMEs. It was followed by the productivity gain in the SOE segment. However, there are differences in the patterns of productivity growth. While in the case of private firms productivity gains came along with rising employment, in the case of the state-owned and privatized enterprises, they are attributable largely to labor shedding. For example, the average number of employees in a loss-making SOE fell from 227 to 186 between 1996 and 2000. Loss-making private enterprises and loss-making SOEs were the leaders in productivity growth with productivity increases of 347 percent and 67 percent, respectively, well above the 33.9 and 9.3 percent increase in their wage costs. However, in absolute terms, the value added per employee in these two loss-making groups remains well below that of their profitable counterparts.

**Table 5.3: Productivity Trend, 1996 – 2000 (Value-Added in Constant 1996 HRK per Employee)**

<b>Ownership Category</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>% Change 1996-2000</b>
State-owned						
- profitable	81,331	104,977	109,215	108,368	105,299	29.5
- loss-making	38,798	27,513	28,566	47,691	64,817	67.1
- average	58,053	70,262	70,066	76,333	79,604	37.1
Privatized						
- profitable	92,021	97,272	97,707	100,064	105,044	14.2
- loss-making	37,490	39,885	44,663	44,428	37,341	(0.4)
- average	72,904	78,880	78,424	80,395	83,480	14.5
Private						
- profitable	59,114	69,314	69,551	89,210	83,039	40.5
- loss-making	8,114	9,678	21,997	31,448	36,237	346.6
- average	50,796	60,645	60,278	77,344	74,233	46.1
Total	61,231	70,410	69,515	78,037	78,592	28.4

Source: FINA.

5.15 The evidence of corporate restructuring in SOEs and privatized enterprises is quite mixed with SOEs and, in particular, loss-making SOEs greatly increasing their productivity over the period 1996-2000 while, in contrast, the productivity of privatized enterprises falling slightly. This suggests that arrangements for corporate governance in privatized enterprises are even weaker than those in SOEs and that the privatized enterprises are able to operate mainly for the benefit of their managers and employees. Interestingly, real wages in the SOE sector—which were slightly lower than in privatized enterprises—were 47 percent higher than in private firms in 1996 but 63 percent higher in 2000 (average real wages in the SOEs rose more than twice as fast as average wages in private firms). Comparison of productivity growth with average real wage growth shows that private firms made the larger gains; 36.6 percent over 1996-2000, followed by privatized enterprises, 17 percent and SOEs, 14.8 percent.

5.16 Financial performance confirms that the private sector is the most dynamic source of enterprise savings and thus the main source of potential investment. As shown in Table 5.4, the enterprise sector generated net losses during each year from 1996 to 2000, with only private companies recording net profits every year. The performance trend has been uneven with a significant improvement achieved in 1997, followed by deteriorating results in 1998 and 1999, and then another significant improvement in 2000. Net losses were heavily concentrated in the SOE sector—on average 4.6 percent of GDP—although loss-making privatized enterprises also showed losses equivalent on average to 2.6 percent of GDP. Even among the group of loss-making enterprises, there is a heavy concentration of losses in a small group of large enterprises which, in turn, absorb a high share of employment and bank debt. These firms tend to pay wages which are far higher than the average even though often they have negative gross earnings or even sometimes negative value added (Box 5.1).

**Box 5.1: The Large Loss Makers**

Losses are quite concentrated with 19 loss-making enterprises generating losses of 2.7 percent of GDP or 40 percent of the total losses generated by all loss-making enterprises in 2000. This group of enterprises had 73,500 employees, or about 10.3 percent of total enterprise sector employment, who earned an average wage which was 35 percent higher than the average wage in the enterprise sector. The 19 largest loss-makers have bank debts of HRK7.1 billion or about 13.2 percent of total bank loans to the enterprise sector at the end of 2000. Nine of the 19 largest loss-makers appear to be severely distressed since they reported negative gross earnings (value added minus wages) and four of the nine also reported negative value-added.

Losses are further concentrated within this group, with the five largest loss-makers accounting for 20 percent of enterprise sector losses in 2000. The five largest loss-makers are also very important job providers with combined employment representing 7 percent of total employment in the enterprise sector. The five include one enterprise from the electricity, gas and water sector with 15,000 employees, three from the manufacturing sector with a total of 18,200 employees and one from the transport sector with 18,500 employees. The average wage paid by the five largest loss-makers is 40 percent higher than the average wage paid in the enterprise sector. As a group, the five largest loss-makers are large debtors to the banking system since they represent 11 percent of the total bank debt of the enterprise sector. As a group, they are also rather illiquid with a current ratio of 0.4. Individual current ratios within the group range from 0.3 to 0.99. As a result, four of the five largest loss-makers have large arrears to suppliers ranging from 5.6 to 11.8 months of purchases.

**Table 5.4: Enterprise Sector Net Profits (losses) 1996 – 2000 (% of GDP)**

<b>Ownership Category</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
State-owned					
- profitable	0.99	1.73	0.91	1.08	1.15
- loss-making	(7.06)	(3.55)	(3.91)	(5.09)	(3.91)
- total	(6.08)	(1.82)	(3.00)	(4.00)	(2.76)
Privatized					
- profitable	2.20	2.33	1.84	2.14	2.83
- loss-making	(2.27)	(2.75)	(2.88)	(3.03)	(2.30)
- total	(0.08)	(0.42)	(1.04)	(0.88)	0.53
Private					
- profitable	2.62	2.39	2.18	2.52	2.97
- loss-making	(1.20)	(1.21)	(1.73)	(2.04)	(1.74)
- total	1.43	1.19	0.45	0.47	1.24
All enterprises					
- profitable	4.82	4.73	4.02	4.66	5.80
- loss-making	(9.54)	(5.77)	(7.61)	(9.07)	(6.80)
- total	(4.72)	(1.05)	(3.59)	(4.41)	(1.00)

Source: FINA.

5.17 Financial markets appear to recognize the relative dynamism of private firms. A breakdown of enterprise assets and their financing according to type of ownership in Table 5.5 shows that the private enterprises (mainly SMEs) are the most dependent on external sources of financing. Suppliers, other accounts payable, banks and shareholders

provide about 77 percent of their total financing while retained earnings provide for only 4 percent of their financing. They are highly leveraged with debt providing for 78 percent of their financing. It is noted that, unlike the SOEs and privatized enterprises, the assets of the private enterprises consist mainly of current assets (accounts receivable and inventories), which, under the present legal framework, are difficult to use as collateral for secured lending. Only 29 percent of the assets of the private enterprises are in the form of land buildings and equipment, as compared to 50 percent and 67 percent, respectively, in the cases of privatized enterprises and SOEs. Despite difficulties for providing collateral, private firms debt with banks experienced a five-fold increase over 1996-2000, compared to 52 percent in the case of privatized enterprises and 27 percent in the case of SOEs.

## **B. THE FINANCIAL SECTOR**

5.18 Since the implementation of measures to rehabilitate the banking system in 1996, the Croatian financial sector has been transformed. By early 2002, the banking system was almost wholly foreign owned; had undergone a major period of consolidation; there had been improvements in banking regulation and supervision; and, an increasingly competitive market for banking products and services had developed.

5.19 In the non-banking sector, there had also been progress in development of the capital markets and the introduction of a new pension system which should provide strong demand for both debt equity products over the long term. This section provides an overview of the banking sector followed by a description of developments in capital markets and the insurance sector.

### **Banking Sector**

5.20 The banking sector in Croatia has developed into a strong and stable system distinguished by the highest level of foreign ownership in the transition countries. The stability of the system was most recently demonstrated in early 2002 by the near-insolvency of Rijecka Banka d.d. (the third largest bank) as a result of an alleged foreign exchange trading fraud. The handling of the ensuing run on the bank—which was overcome by the rapid organization of a liquidity safety net provided the CNB and subsequently bolstered by other commercial banks—and very rapid re-privatization of the bank by sale to another foreign strategic investor already operating in Croatia, are indicators of the resilience of the system and the well-developed crisis management skills of the banking authorities.<sup>90</sup>

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<sup>90</sup> The CNB asserts that it is impossible for supervisors to “catch” this type of fraud but is also reviewing its procedures to determine if improvements are required. Similar frauds at Allied Irish Bank (in its US subsidiary) and Barings Bank were also not detected by either regulators or auditors.

**Table 5.5: Balance Sheets – 2000 (HRK million)**

<b>Type of Enterprise</b>	<b>SOEs</b>	<b>Privatized</b>	<b>Private</b>
Current Assets			
- Cash and Other	2,620	2,561	5,116
- Accounts Receivable	16,971	20,605	36,850
- Inventories	10,202	11,596	18,423
<b>Total</b>	<b>30,166</b>	<b>35,162</b>	<b>60,624</b>
Financial Investments	14,601	19,172	15,110
Other Claims	2,548	1,204	913
Fixed Assets	118,380	57,521	34,170
Other Assets	8,586	3,822	6,952
<b>Total Assets</b>	<b>174,621</b>	<b>117,020</b>	<b>118,330</b>
Current Liabilities	43,195	34,703	70,348
- Accounts Payable			
- Suppliers	14,437	15,079	35,448
- Wages	1,614	1,419	2,113
- Taxes	3,101	2,854	3,271
- Short term bank debt	4,866	4,567	6,499
- Other	19,177	10,783	23,016
<b>Long Term Liabilities</b>	<b>26,205</b>	<b>18,432</b>	<b>21,664</b>
- Bank Debt	14,071	12,513	11,251
- Other Loans	7,698	2,506	6,172
- Other LT Debt	3,417	2,445	2,630
- Provisions	1,019	968	1,611
<b>Total Liabilities</b>	<b>69,401</b>	<b>53,135</b>	<b>92,012</b>
Capital	103,368	58,365	21,184
Retained Earnings	1,853	5,520	5,134
<b>Total Equity</b>	<b>105,221</b>	<b>63,885</b>	<b>26,318</b>

*Source:* FINA.

5.21 The banking system has followed a path typical of the more advanced transition countries in the region.<sup>91</sup> Starting in 1991, there was a very rapid growth in the number of banks as private institutions were founded to take advantage of the crippled state of all except one of the large state banks. This growth in numbers peaked in 1997 as the state banks began to emerge from the first stage of the rehabilitation process and the private banks engaged in ever-riskier (and legally questionable) lending to insiders and marginal enterprises. In early 1998, the CNB implemented a program of diagnostic supervisory audits directed largely at the fastest-growing private banks. The simultaneous failure of Dubrovacka Banka, which was placed in rehabilitation rather than allowed to go into bankruptcy, led almost immediately to depositor runs on some of the banks selected for diagnostics (perhaps proving that ordinary depositors are often not unaware of the

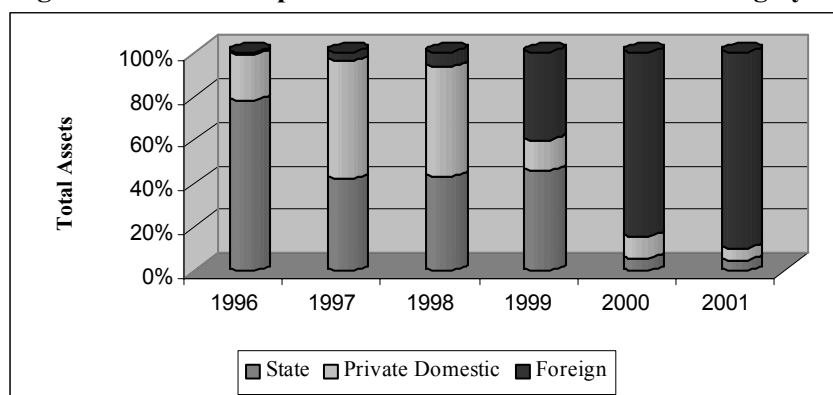
<sup>91</sup> The phasing of the development of the banking system in Croatia is mirrored by that of the Czech Republic and the Slovak Republic.

relationship between above-market deposit rates and high risk lending). As a result of the CNB's diagnostic supervision, some 11 banks were closed in 1998 and 1999 and two savings banks had their licenses revoked in 2000 (Box 5.2).

#### Box 5.2: The Banking Crisis of 1998 – 1999

- Liquidity crisis at Dubrovacka Banka triggered a crisis of confidence in fast growing private banks.
- The Ministry of Finance increased the level of deposit insurance five-fold to HRK100,000 in an attempt to stem the developing crisis and limit political damage.
- Reinforced by the CNB's decision to initiate diagnostic supervision for 12 banks in spring 1998.
- Vukovarska Banka was closed in 1998 as a result of losses suffered during the war.
- There was significant political pressure placed on the CNB not to close banks which were linked to the ruling party. Partly as a result, the CNB was unable to close the banks until the enactment of the new Banking Law in December 1998.
- Bankruptcy proceedings were initiated by the CNB against: Ilirija, Glumina, Gradska, Komercijalna, Zupanska and Neretvansko-gospodarska, Trgovacko-turisticka, Agroobrtnicka, Hrvatska gospodarska, Promdei, banks and four savings banks.
- The deposit insurance fund administered by the DASB could not meet the demands on it from depositors in the failed banks. Depositors in most banks were not finally paid off until 2000 when the DASB raised EUR 330 from a domestic bond issue.

Figure 5.1: Ownership of the Assets of the Croatian Banking System



Source: CNB.

5.22 By 2000, the banking system had entered a phase of rapid consolidation and the emergence of foreign ownership as a distinguishing feature of the system (Figure 5.1). Consolidation was driven by three factors. First, the rapid exit of domestic private banks chiefly as a result of failures. Second, there have also been a limited number of mergers as smaller banks sought partners in the face of increasing competition in the market as the rehabilitated state banks and entering foreign banks began to compete with new products and technology. Without the ability to develop economies of scale in information technology and product delivery systems, these banks could not be (outside of niche markets) competitive with the large banks. The CNB recognizes this commercial reality and is actively encouraging non-viable banks to exit through voluntary liquidation or merger. Third, the privatization of the banks in rehabilitation led to the entry of major

foreign strategic investors in 2001 and, in 2002,<sup>92</sup> a final phase of consolidation is beginning as foreign-owned bank groups begin the process of merging their acquisitions into single banking units (Table 5.6).

**Table 5.6: The Croatian Bank Rehabilitation Program**

<b>Bank</b>	<b>Year of rehabilitation decree</b>	<b>Year of majority privatization</b>	<b>Estimated cost *of rehabilitation (mm euro)</b>	<b>Sold to</b>
Slavonska	1995	1999	22	Hypo-Alpe-Adria (72%) EBRD (16%)
Rijecka	1997	2000	80	Bayerische Landesbank (60%) then resold to Erste (93%)
Splitska	1997	2000	110	Unicredito (63%). Resold to HVB Bank Austria in 2002.
Privredna	1997	2000	1,126	BCI Intessa (66%)
Dubrovačka	1998	2002	335	Charlemagne (95%)
Croatia	1999	N/A	56	
<b>TOTAL</b>			<b>1,729</b>	

It is impossible to provide a definitive estimate of the costs of rehabilitating some banks (Privredna, Splitska, and Dubrovačka). In these cases, either the original structure of the rehabilitation, transactions during the rehabilitation process, or transactions incorporated into the privatization process (or all three) involved the purchase of assets by the DASB in exchange for notes. Data regarding the results of liquidation of these assets, which would provide an estimate of the net cost or benefit derived from the assets, is not available and/or the liquidation of the assets has not yet been completed. In addition, three significant items are excluded (a) the cost of the “Big Bonds” (these bonds were issued in 1993 to compensate enterprises for losses incurred as a result of physical destruction during the war). The bonds were then passed by the enterprises to the banks as payment for outstanding loans. The bonds originally paid no interest but, in 2000, were made interest bearing in order to support the recapitalization of the banks mentioned in point (c) of this footnote) provided to all eligible banks; (b) frozen foreign currency bonds also provided to all eligible banks; and (c) the second Rijecka Banka transaction – in 2002 – which was carried out without use of the Law on Rehabilitation of Banks. Further, in 2000, the terms of the “Big Bonds” were adjusted for the benefit of the holders and, as a result, Istarska Banka and Cibala Banka were also recapitalized without use of the Rehabilitation Law.

*Source:* Bank Rehabilitation in Croatia, Lovegrove, 1998.

5.23 In addition to being increasingly concentrated in terms of ownership (Figure 5.2), the system continues to be highly concentrated by the size of banks. The two largest banks (Privredna Banka and Zagrebacka Banka) have never controlled less than 40 percent of the assets of the system and at end-2001, the share of the four largest banks amounted to 60 percent of total assets, with the two largest banks controlling 46 percent.<sup>93</sup> In the medium term, the concentration of ownership in four large bank groups

<sup>92</sup> Slavonska Banka was privatized in 1997, Privredna Banka, Rijecka Banka, and Splitska Banka in 2000, and Dubrovačka Banka in 2002. Attempts to privatize Croatia Banka in 2001 and 2002 failed and the DASB has now proposed merging it with Hrvatska Postanska Banka.

<sup>93</sup> The reduction in market share of the largest banks in the 1996 to 1998 period was driven almost exclusively by the temporary phenomenon of the wild expansion of a few domestic private banks (Glumina, Gradska and Dubrovačka), all of which became insolvent in 1998.

is likely to continue as a feature of the system. Recent developments such as the acquisition of Splitska Banka by HVB Bank Austria and Rijecka Banka by Erste Banka—where both acquirers are adding on to an existing franchise and seeking both additional economies of scale and broader geographical distribution for their products—will tend to reinforce concentration. This will in turn be reinforced by the eventual sale of the Nova Banka group,<sup>94</sup> within the next three to five years.

**Figure 5.2: Major EU Parent-Owned Croatian Banking Systems**

Origin	Germany	Italy		Austria		
Parent Bank	HVB	BCI Intessa	UniCredito	Hypo-Alpe-Adria	Rafeissen	Erste
Croatian Subsidiaries	HVB Bank Austria	Privredna Banka	Zagrebacka Banka	Slavonska Banka	Rafeissen Banka	Rijecka Banka
	Splitska Banka		Cassa di Risparmio di Trieste Banka	Hypo-Alpe Adria Banka		Erste Banka

Source: CNB.

5.24 By the middle of the decade it is reasonable to expect that the banking system will be dominated by these five or six “national” banks with a second tier of foreign owned, but significantly smaller, competitors. In turn, the banking system will continue the trend of becoming fully integrated with EU-based multinational banking networks which have spread across Central Europe and are now spreading throughout the former Yugoslavia.

5.25 Since the banking crisis of 1998–1999, the banking system has grown rapidly with the return of depositor confidence (Table 5.7). The decision to issue bonds in 2000 in order to allow the DASB to honor in full outstanding deposit insurance claims from the failed banks was one critical measure in restoring confidence. A second factor—applying almost exclusively to 2001’s growth of over 53 percent in foreign currency deposits—was the euro conversion process which saw the entry of very large amounts of “under the mattress” savings into the banking system. This is a useful measure of confidence: the bulk of these deposits have so far remained in the banking system and there seems little sign that citizens are merely depositing and then withdrawing these funds in order to avoid conversion fees.

5.26 Despite the heady growth of the last two years, it is unlikely that this pace can be sustained. The euro conversion process was a one-off opportunity to draw resources into the banks and in itself offers challenges for the future: banks offered attractive interest rates in order to attract these deposits but must now find opportunities to lend these funds prudently or profitability will be affected. As discussed below, this presents the greatest medium-term challenge to the banking system.

<sup>94</sup> Formed by Charlemagne Capital in 2002 through the merger of Istarska, Dalmatinska and Sisacka banks. Dubrovačka Banka is expected to be merged into the group in 2003/2004. Charlemagne has clearly indicated its intention to sell the group in the medium term.

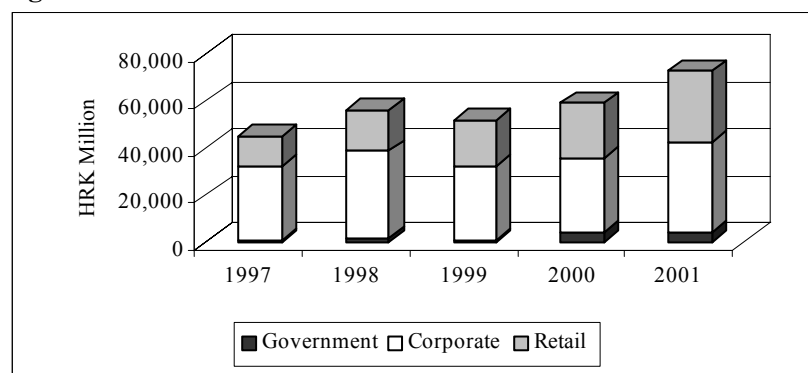
**Table 5.7: Balance Sheet of the Croatian Banking System (in million euros)**

<b>Item</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
<b>Assets</b>					
CNB Reserves	726	806	1,170	1,394	2,015
Foreign Deposits	2,330	1,741	1,615	2,594	4,407
Claims on Central Government	2,194	2,028	2,118	2,511	2,708
Claims on Local Governments	44	89	118	155	172
Claims on Enterprises	5,108	5,625	4,590	4,723	5,761
Claims on Households	1,842	2,417	2,507	3,066	4,046
Claims on Banks	0	0	6	6	10
Claims on Financial Institutions	36	26	20	21	38
<b>Total Assets</b>	<b>12,280</b>	<b>12,734</b>	<b>12,144</b>	<b>14,470</b>	<b>19,157</b>
<b>Liabilities and Capital</b>					
Demand Deposits	1,213	1,065	1,028	1,498	2,039
Savings Deposits	806	776	703	1,007	1,372
Foreign Currency Deposits	4,502	5,181	4,814	6,173	9,650
Bonds and Money Market	19	21	57	63	43
Foreign Liabilities	1,987	2,207	2,241	2,344	2,936
Central Government Deposits	990	996	759	886	757
Borrowing from CNB	5	143	148	43	2
Restricted and Blocked Deposits	842	573	447	336	215
Capital	2,451	2,700	2,862	3,284	3,420
Net Other Items	-535	-927	-915	-1,163	-1,277
<b>Total Liabilities and Capital</b>	<b>12,280</b>	<b>12,734</b>	<b>12,144</b>	<b>14,470</b>	<b>19,157</b>

*Source: CNB.*

5.27 On the asset side, bank lending has been increasingly driven by retail loans and limited exposure to Government (Figure 5.3). While retail lending has been a trend in banking during the 1990s, a significant increase in corporate loans since 2000 reveals bank's competitiveness vis-à-vis capital market options of corporate financing.

5.28 The banking system is well capitalized and profitable by European standards. Profitability is generating capital at about 1.5 percent of assets per year. The fact that over 90 percent of the banking system is owned by strong strategic partners implies that the system is well placed to raise additional capital if business circumstances require it. There is scope for improvement in profitability as assets per employee remain well below those found in Western Europe and the United States, indicating that the industry in Croatia suffers from low rates of productivity which could be enhanced by rationalization and improvements in information technology.

**Figure 5.3: Structure of Banks' Loan Portfolios**

Source: CNB. The data is sufficiently detailed to allow analysis of sub-categories of borrowers.

5.29 Loan quality has continued to improve since the 1998 crisis despite more effective supervision by the CNB, and provision coverage of C to E graded loans remained above 72 percent at year-end 2001 (Table 5.8). Despite this satisfactory ratio, some problem banks remain within the system, none of which pose any systemic threat.

5.30 One issue which has not been fully addressed is the risk posed by the “euroization” of the Croatian economy which is reflected by the overwhelming proportion of deposits held in foreign currency (Table 5.9).

**Table 5.8: Indicators of the Health of the Banking System**

Item	Capital indicators			Loan quality <sup>1/</sup>		Primary liquidity Ratio <sup>2/</sup>
	Capital	ROA	ROE	A & B	C to E	
1998	12.7	-2.8	-16.1	90.7	9.3	1.65
1999	20.6	0.7	4.8	89.7	10.3	1.30
2000	21.3	1.4	10.7	90.5	9.5	3.32
2001	17.5	0.9	6.6	92.7	7.3	3.23

1/ Loan classification is made according to IAS 39. The classifications are equivalent to US-convention regulatory classifications: ‘A’ = Standard; ‘B’ = Watch; ‘C’ = Substandard; ‘D’ = Doubtful; and ‘E’ = Loss. Collateral is used to offset provision requirements on the basis of discounted projected realizable cash flow from liquidation. This should take into account the long delays and uncertainties attached to the realization of collateral within the Croatian debt enforcement framework.

2/ Free reserves to deposits ratio.

Source: CNB.

**Table 5.9: Consolidated Net Foreign Currency Exposure of Banks Including the CNB (in euro million)**

<b>Item</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Bank FX Assets	2,330	1,741	1,615	2,594	4,407
CNB FX Assets	2,304	2,400	3,013	3,783	5,281
<b>Total FX Assets</b>	<b>4,634</b>	<b>4,142</b>	<b>4,628</b>	<b>6,377</b>	<b>9,688</b>
Bank FX Liabilities	6,490	7,388	7,055	8,516	12,587
CNB FX Liabilities	212	200	218	215	215
<b>Total FX Liabilities</b>	<b>6,702</b>	<b>7,588</b>	<b>7,273</b>	<b>8,731</b>	<b>12,801</b>
<b>FX Assets/Liabilities (%)</b>	<b>69.14</b>	<b>54.58</b>	<b>63.63</b>	<b>73.04</b>	<b>75.68</b>

*Note:* Consolidation deducts foreign currency reserves placed by banks with the CNB.

*Source:* CNB.

5.31 While the foreign currency assets to liabilities ratio of the banking system of 41.1 percent in 2001 appears to be potentially very risky, the scale of the risk is less because (a) Croatian banks hedge by indexing credit exposures to the euro; (b) increasingly make loans in euro, a factor which is not distinguished in the data with respect to loans to enterprises; and, (c) are required by regulation to limit their net foreign currency exposure to 20 percent of regulatory capital.

5.32 The Croatian banking system, which introduced a deposit insurance scheme in 1997 (Box 5.3), has now achieved stability after five years of intensive rehabilitation and the disappearance (at great cost to the State) of domestic private banks as a major factor in the market. However, this stability is not a sign that the banking system will now be able to prudently fulfill its full intermediation function. Rather, bankers identify very severe problems in the operation of the Croatian legal system which pose an obstacle to prudent lending and which may, in the medium term, lead to significant deterioration in the system and its failure to fulfill its key role in supporting economic growth.

5.33 Understanding and addressing the impact of the legal framework on the economy should become an absolute priority for the Croatian authorities. As discussed in the next section, the malfunctioning of the legal framework adversely affects not just banks but all creditors in the economy and has real and quantifiable costs: a recent EU report concluded that "...the overall situation is discouraging for foreign investors and inhibits growth by domestic investors."<sup>95</sup> The banking system will not be able to fully achieve its intermediation functions until action is taken to cure this problem. Croatia has a legal framework which appears to be very 'debtor friendly' as creditors cannot use the legal system effectively as means to enforce their claims. In fact—and this is a point which should be very strongly borne in mind by the authorities—the framework has become very 'debtor unfriendly' because viable borrowers are cut off from credit or can secure far less credit (and at higher interest rates) than they might be able to secure within a better framework for the enforcement of creditor rights.

<sup>95</sup> *Croatia Stabilization and Accession Report*, April 2002. Commission of the European Communities.

**Box 5.3: The Croatian Deposit Insurance System**

- Croatia introduced deposit insurance in 1997. The system is administered by the State Agency for Deposit Insurance and Bank Rehabilitation (DASB), an independent agency of the Government operating with a full state guarantee of its liabilities.
- Membership of the system is obligatory for all banks and savings banks that collect citizens' deposits.
- Deposits are insured for HRK100 thousand (US\$13,000) per depositor per bank. 95 percent of deposit accounts and 60 percent of the value of deposits is insured by the system.
- Banks pay an annual premium of 0.8 percent of insured deposits (paid quarterly).
- The initial capital of the fund was created using a contribution of 0.3 percent of banks' capital.
- The fund became insolvent in 1998 as a result of the banking crisis and manipulation of the system by depositors (many deposits in failing banks were “renamed” to secure coverage by using multiple family members or by transferring corporate accounts into the names of individuals. As a result, 90 percent of deposits in failed banks were insured by the time they entered bankruptcy). The DASB continues to fight cases of deposit “renaming” in court.
- All delinquent insurance liabilities were paid off as a result of a bond issue in 2000.

## Capital Markets

5.34 The Croatian capital markets are still very much in the developmental stage and the Government has made no commitment to prioritize capital markets development as an important pillar for the future development of the economy. This lack of commitment has been demonstrated by the preference shown for trade sales of important SOEs over public offerings. This point is reinforced by the lack of financial and human resources available to the Securities and Exchange Commission (CROSEC) to perform its work. The introduction of pension system reforms in 2001 brings the need for a commitment to capital market development—and particularly development of the market for domestic corporate debt securities and equities—into sharp focus. As discussed below, the pension funds do not have a satisfactory means of diversifying either their portfolios or their risks and over time will face difficulties in generating the returns from debt products required to provide satisfactory pensions to plan participants. However, the new Securities Law (in force since July 2002) requires compulsory listing of companies issuing shares on public offerings or having more than 100 shareholders and a share capital of at least HRK30 million. These companies must list their shares on a stock exchange by July 2003. This measure should boost capital market development.

5.35 Two stock exchanges operate in Croatia: the Zagreb Stock Exchange (ZSE) and the Varazdin Stock Exchange (VSE). The main exchange is the ZSE. A first level listing requires a company to meet all international requirements for accounting and transparency while the second level requirements are less restrictive. The VSE market exists primarily for the benefit of the Privatization Investment Funds (PIFs), which also

exercise a controlling influence over the exchange itself. Securities clearing and depository services are provided by a separate state controlled<sup>96</sup> company, the Croatian Securities Depository Agency (CDA).

5.36 The ZSE was founded in 1991 and has operated without interruption since that time. Turnover remains very modest and is falling as a percentage of GDP. International investment through the ZSE has been concentrated in the very small number of first listing companies, particularly Zagrebacka Banka and Pliva, which are both also listed on the London International Exchange. Market capitalization has been growing slightly as a percentage of GDP in the last three years but, at the end of 2001, remained at only 71 percent of the level reached in 1997, with foreign-source trading accounting for about 75 percent of trading<sup>97</sup> (Figure 5.4). The de-listing in 2002 of Zagrebacka Banka (as a result of its acquisition by UniCredito Italiano), which accounted for 21 percent of market capitalization in 2001, reduced the size of the market. Even so, turnover increased significantly in 2002 as investors switched to other stocks and placed more emphasis on bonds (Figure 5.5).

5.37 The failure of the ZSE to expand in line with the economy can be attributed to a number of factors:

- The State has not taken opportunities arising from the privatization of SOEs to force listing of these companies through public offerings of minority stakes and still has not listed all of its bonds on the ZSE.
- Larger companies are able to borrow from banks at significantly lower rates (about 1.5 percent less due to fees and expenses) than those payable on corporate bonds. This creates a rational cost-based preference for debt over equity on the part of potential bond issuers, and is a condition which will continue to apply so long as there are very high levels of competition between banks for “blue chip” Croatian lending business.
- Croatian companies are unwilling to provide the level of disclosure required for a first listing. This reflects the lack of a more general requirement for larger enterprises to provide public information or to have IAS audits. The Government has drafted amendments to the Companies Law to improve governance and transparency;<sup>98</sup> and,
- The management of Croatian companies seeks to maintain control by avoiding the capital markets. Equity activities are focused on the Employee Stock Ownership Plans (held by management-controlled trusts) to further concentrate controlling shareholdings in the hands of management.<sup>99</sup>

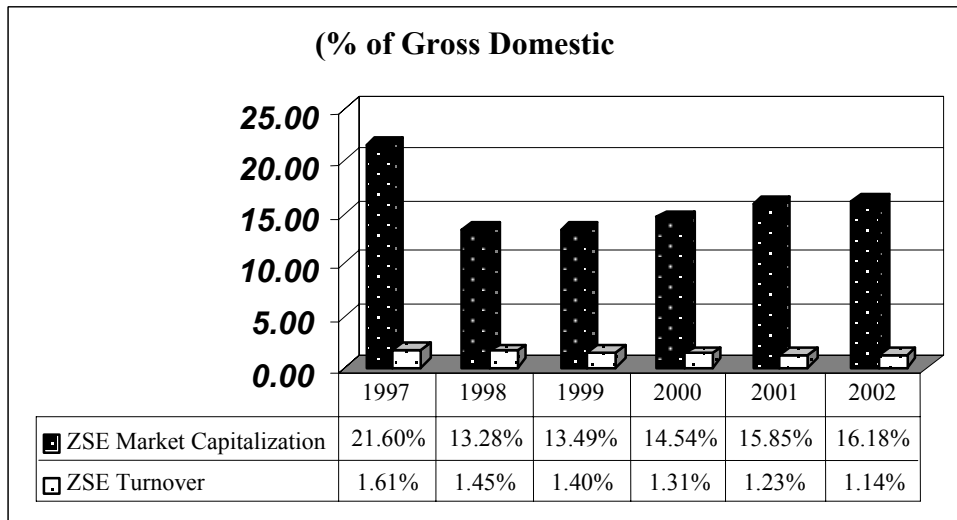
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<sup>96</sup> CDA’s ownership structure is: Republic of Croatia 62.2 percent; FINA (former ZAP) 15 percent; and, market participants (brokers, etc.) 22.8 percent.

<sup>97</sup> ZSE estimate. Source for Figure 5.4 is ZSE.

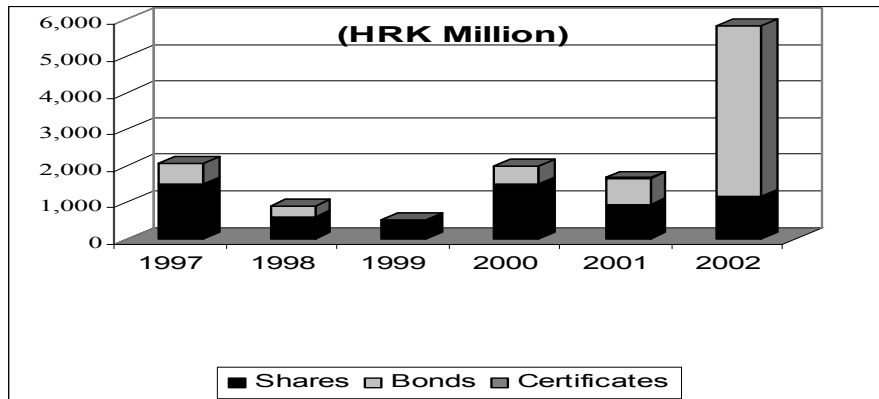
<sup>98</sup> The amendments are expected to be submitted to Parliament in the first quarter of 2003.

<sup>99</sup> One large Croatian company is reported to be paying fines to the Central Depository Agency rather than turn over control of its stock register. Consequently it (along with a number of others) has shares which cannot be traded on the ZSE as there is no guarantee that once purchased the ownership of a share can be

**Figure 5.4: Zagreb Stock Exchange**

Source: ZSE.

5.38 As a result, the predominant proportion of ZSE turnover is now in the form of state bond trading rather than equities or corporate bonds (Figure 5.5).

**Figure 5.5: Turnover on the Zagreb Stock Exchange by Instrument Traded**

Source: ZSE.

5.39 On the VSE, there is presently only one first level listing and, due to the lack of transparency and market regulation, there appears to be a high risk of share price manipulation, particularly as PIF managers have a significant financial incentive (2 percent of their fund's market value) to ramp up their own prices prior to their required conversion into closed end funds during 2002.

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registered. This method has also been widely used by Russian companies as a means to block the entry of investors considered "undesirable" by management.

5.40 Securities regulation is carried out by the Croatian Securities Commission operating within the framework of the Securities Act (the Commission was established in late 1996). A new Securities Law was passed in 2002. The Commission's functions are (a) development of securities regulations; (b) licensing of brokers and brokerage firms; (c) approving prospectuses and other securities filings; (d) monitoring transactions of the ZSE and VSE; (e) investigating and enforcing regulatory and legal compliance; (f) development of training and professional licensing programs for brokers; and, (g) cooperation with international securities bodies (the SEC is a member of the International Organization of Securities Commissions). The five commissioners are appointed by Parliament on the recommendation of the Government.

5.41 The SEC itself describes its powers as very limited and its enforcement activities as ineffective. Judicial rulings have held that the Commission has only the power to issue brokerage licenses but not to revoke them and it has no power to levy fines or impose other penalties and of 51 cases referred to the public prosecutor about 75 percent have simply been allowed to lapse. Where judges have imposed penalties, these have generally been very minor compared to the profits achieved by the defendants. As a result, it is unable to impose discipline on market participants or curb abuses.

5.42 The legal weaknesses identified above were addressed by the new Securities Law adopted in 2002. However, significant institutional strengthening will be required before the Commission can function effectively as a regulator. Staff salaries were cut sharply by the present government (causing experienced professional staff to leave) and the Commission finds it impossible to recruit qualified and experienced replacements – current pay levels for experienced lawyers are only 20 to 25 percent of those available in the private sector. It is presently staffed at only 60 percent of target and, in any case, has no funds available to provide offices if it were to succeed in recruiting additional staff. Clearly the SEC requires urgent attention and a significant additional allocation of resources if it is to be able to perform its regulatory function.

### **Pension Funds**

5.43 The pension system reform of 2001 moved Croatia from a pay as you go system to a three pillar system. All persons under 40 years of age on January 1, 2002 were required<sup>100</sup> to contribute 5 percent<sup>101</sup> of their wages to regulated pension funds and persons between 40 and 50 years of age on the same date were also permitted to contribute to such funds. Registration of pension fund participants is administered by REGOS while the funds themselves are regulated by HAGENA.<sup>102</sup> Seven funds were

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<sup>100</sup> Employers are required to deduct statutory contributions from wages and salaries.

<sup>101</sup> An additional 15 percent of gross wages is taken as a contribution to the state pension system (from employee contributions).

<sup>102</sup> Both institutions appear to be adequately and professionally staffed with an adequate infrastructure to support their regulatory functions. Given the very limited scope of investments allowed to pension funds, the regulatory challenges are presently small. Over time, and assuming investment restrictions are loosened, HAGENA will have to develop increasingly sophisticated skills to assess the quality of investments made by the funds and ensure that the funds' accounting is accurate. Given the importance of

formed (primarily as subsidiaries or joint ventures of banks) to attract participants.<sup>103</sup> Any fund must attract not less than 80,000 members before the end of 2003 in order to remain in business, a target as yet achieved by only three funds, and there is consequently an expectation that many funds will merge (some mergers being in any case driven by mergers between the parent banks). The funds are exclusively compensated through a front load fee of 0.8 percent and an annual management fee of 0.8 percent of the fund balance.

5.44 Under the present law and regulations, the pension funds operate under conservative investment restrictions. For example, no more than 15 percent of funds may be invested in foreign securities, which must be rated AA or better; and all other funds may only be invested in first listing Croatian securities.

5.45 These restrictions are perhaps appropriate for the first years of the operation of the funds in order to avoid the possibility of discrediting the reform as a result of a scandal. However, in the medium term, the investment options available do not offer either (a) the opportunity to diversify portfolio risk or to generate real returns sufficient to pay meaningful pensions to plan participants; or, (b) opportunities to match investment maturities with the timing of the pension funds' liability to start paying pensions. Over time, investment restrictions will have to be loosened to allow the funds to diversify risk geographically (outside Croatia) and to diversify by sector and investment type and maturity within their portfolios. At the present time, the funds are effectively (with the exception of foreign debt securities) restricted to investing in two ZSE-listed equities<sup>104</sup> and Croatian government debt. Under these circumstances, and with the funds growing through annual contributions estimated in the HRK2 to HRK2.5 billion range, it is unlikely that real competition between the funds based on comparative performance can emerge – reasonably competent managers will, in all cases, produce more or less equivalent performance.<sup>105</sup>

5.46 A further problem faced by the pension funds is simply their size in relation to the market. About HRK2 billion was gathered in the first year, which led to a tripling of market turnover in one year (Figure 5.5). Restricting the fund to investment in first list securities, however, implies that pricing of both debt and equity securities will become driven by an unnatural demand and that valuations may reach levels which bear no rational relationship to the value of the underlying enterprises. If this situation is to be avoided, either the pension funds must be allowed to invest a significantly greater portion of their funds abroad (which would be advisable in any case in order to diversify geographic risk) or the supply of eligible investments in Croatia must be increased.

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the pension funds, the authorities must ensure that the required fiscal resources are provided to HAGENA to continuously upgrade the skills of its staff and retain them.

<sup>103</sup> Persons who had not selected a fund by March 31, 2002, were randomly assigned to a fund.

<sup>104</sup> Of the three first list ZSE equities, (Zagrebacka Bankawas de-listed) one is in financial difficulties.

<sup>105</sup> The fund managers' options are basically limited to asset weighting within their portfolios. There is little scope for successful investment selection given the lack of investments to select from.

5.47 Lastly, the funds presently face significant foreign exchange risk as the government debt they are investing in is predominantly either denominated in or indexed to the euro while pension benefits are to be paid in kuna. Over the medium term, this problem could be resolved by the entry of Croatia into the euro zone and consequent redenomination of benefits obligations into euro. Pending this, and to hedge against the risk that such a scenario will not occur, the Ministry of Finance should denominate government debt issued domestically in kuna without euro indexation. This would have the added advantage of reducing the Government's own substantially foreign exchange risk while easing short-term appreciation pressure on the kuna.<sup>106</sup>

**Table 5.10: Composition of Croatian Central Government Debt (HRK millions end 2002)**

<b>Item</b>	<b>Outstanding Debt</b>	<b>% of GDP</b>	<b>% of Domestic Debt</b>	<b>% of Total Debt</b>
Frozen Savings Bonds	2,474	1.4	10.0	3.7
Big Bonds and Bank Rehabilitation Bonds	4,775	2.7	19.3	7.2
Other Government-Guaranteed Bonds	8,773	5.0	35.5	13.3
<i>Medium- and Long-Term Debt</i>	19,102	10.8	77.2	28.9
Treasury Bills	5,633	3.2	22.8	8.5
Other Short-Term Debt	1	0.0	0.0	0.0
<i>Total Short Term Debt</i>	5,633	3.2	22.8	8.5
<b>Total Domestic Debt of Central Government</b>	24,735	14.0	100.0	37.5
<b>Foreign Debt of Central Government</b>	41,260	23.4		62.5
<b>Total Central Government Debt</b>	65,995	37.4		100.0

Source: CNB, MoF.

## Insurance

5.48 The insurance sector in Croatia is relatively small and underdeveloped. However, most types of insurance products are now offered on the market. There are no national restrictions on market entry and foreign firms have been able to enter freely.<sup>107</sup> As of end-2002, there were 23 active insurance companies. The industry is evolving rapidly towards the ownership model seen in the banking sector with consolidation of smaller firms already starting (four firms were merged during 2001). The privatization of the dominant insurer, Croatia Osiguranje (which has nearly 50 percent of the market) has still not

<sup>106</sup> The Government has agreed to such a strategy in 2003 under the latest stand-by arrangement with the IMF, but should consider continuing this policy beyond the expiration of this program.

<sup>107</sup> Regulations require that no insurance firm have any one investor which owns more than 15 percent of its voting shares. This requirement has been waived to allow foreign firms to establish wholly-owned subsidiaries in Croatia.

concluded. Just 10 firms control 92 percent of the market and the largest five control more than 75 percent

5.49 The market has been developing well in recent years with the strongest growth coming from the introduction of new products such as comprehensive automobile cover and life insurance along with steady growth in third party automobile insurance. Gross premium income in 2001 was HRK5.1 billion (EUR750 million) with profits rising significantly from HRK46 million in 2000 to HRK173 million in 2001. There are concerns, however, that lax supervision may have led to overstatement of profits and that the industry may be under-reserved.

5.50 The regulatory powers of the Directorate are established by the Law on Insurance. The law gives the Directorate of Insurance Supervision powers to gather information from the industry (firms are required to file quarterly and annual reports) requires that insurance companies be audited, requires certification of technical reserves by an independent actuary, and sets minimum capital levels (HRK15 million for life insurers, HRK18 million for non-life insurers, and HRK33 million for mixed firms). Enforcement powers include the right to force increases in reserves from earnings and capital, and powers to de-license firms, impose restrictions on activities and require the replacement of management. The Directorate has used these powers successfully, imposing restrictions on four firms, de-licensing another, and forcing others to increase reserves. The law also requires firms to maintain constant profitability or else risk restrictions on their licenses—something which would encourage firms to conceal losses—and reform in this area is required. The current law is not EU-compliant and a draft law is now in preparation to bring the legal framework into line with EU directives for insurance. It is planned to introduce the law for passage during 2003.

5.51 Specific weaknesses identified were (a) understaffing and a shortage of technically skilled staff; (b) that the Directorate fails to adequately assess and require reserving for risks in firms portfolios; and (c) that the Directorate is willing to tolerate consistent violation of law and regulations by politically connected domestic firms.<sup>108</sup> Opinion within the industry is clearly very divided, with domestic firms expressing satisfaction with the supervisor and EU firms arguing for stronger supervision.

5.52 The insurance industry faces similar problems to the banking sector (and the capital markets generally) in the investment arena. Specifically, the following problems can be highlighted:

- **Problems with the framework for creditor rights.** Insurers face similar problems to banks with the land register and its impact on their ability to invest in mortgages.

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<sup>108</sup> Specifically cited were widespread practices such as offering “no claims” bonuses to automobile insurance customers without the required accident free qualifying periods, and violations of restrictions on the use of installment payments to pay premiums.

- **Inconsistent and unpredictable judgments.** Insurers face the same problems as bank lenders with inconsistent legal interpretations between courts; and
- **The lack of investment securities.** Insurers identified a lack of investment opportunities in securities such as mortgage-backed bonds and other forms of securitized assets as a problem which limits their ability to diversify risk.

### **C. MARKET FAILURES ORIGINATING IN LEGAL AND INSTITUTIONAL BARRIERS – POLICY RECOMMENDATIONS**

5.53 Croatia has made significant progress towards putting in place the legal and institutional framework necessary to support a favorable investment climate. Relevant laws include the 1993 Company Law, the 2002 Securities Law, the 1997 Law for Takeover of Joint Stock Companies, the 1996 Law on Executive Procedures (execution of mortgages and creation of fiduciary ownership), the 1992 amendments to the Accounting Act (requiring the preparation financial statements according to International Accounting Standards (IAS)), the Audit Law (requiring audits to be carried out by certified auditors in accordance with International Standards of Auditing (ISA)), the 1998 Law on Bankruptcy, and the 1999 Banking Act.

5.54 It has also developed many relevant institutions including the Zagreb and Varazdin securities exchanges (ZSE and VSE), the Croatian Securities Commission (CROSEC), the Croatian Securities Depository Agency (SDA), privatization investment funds, the Croatian Privatization Fund (acting owner and seller of majority state-owned enterprises), the Croatian Bank for Reconstruction and Development (export finance, guarantees and insurance; SME credit programs), the Croatian Agency for Small Business, and the Agency for the Protection of Market Competition (APMC).

5.55 However, while progress has been impressive, much remains to be done to fully put in place all the elements conducive to enterprise and financial sector development. Legal uncertainties concerning property rights and its enforcement through the judicial system constitute a major impediment for new investment. Often unenforceable creditor rights severely constrain financial intermediation which, in turn, is critical for enterprise restructuring. The dilution of creditor's rights in bankruptcy proceedings is yet another factor accounting for limited investment and enterprise restructuring. The main legal and institutional failures that hamper enterprise restructuring and investment are summarized below.

#### **Judicial System**

5.56 The single most important constraint to a favorable investment climate is the absence of an effective judicial system which enforces laws and promotes development by protecting persons and their property and by allowing peaceful and rapid resolutions of disputes. In Croatia, compliance with many of the laws is neither monitored nor enforced. Concerning the judicial system, there seems to be a unanimous view that it is largely ineffective. This is particularly true in cases where regulatory agencies such as

CROSEC and the APMC must refer their findings of illegal behavior to the courts for prosecution. It is also true in case of insolvent enterprises. Widespread non-compliance with and non-enforcement of the law undermines the rule of law and breeds cynicism and disrespect for the law on the part of the general public.

5.57 There is the general problem of lack of common practice, whereby interpretation of the same law may vary from region to region and from judge to judge. However, a much greater problem is a judiciary that lacks the necessary resources and capacity to administer the legal framework, including those laws that regulate the investment climate. Most court procedures are extremely slow and justice delayed is often justice denied. For example, foreclosure on mortgaged property requires the permission of the court. The court must also supervise the auction sale of foreclosed assets. It is reported that an uncooperative debtor can delay the process for many years by challenging the valuation of the foreclosed assets to be offered for sale. He can also petition for a stay of proceedings. Such stays are sometimes granted even though the law does not permit them. An appeal of the stay to a higher court will eventually be successful but it will likely add two years to the execution process. Some banks estimate that it now can take up to five years to execute a mortgage in the Zagreb courts.

### **Recommendations**

5.58 The Government is largely aware of the problems in the judicial system and has already adopted a reform program to address the problem of Croatia's courts in accordance with the spirit of the SAA (Title VII, Article 75). For example, with support under the Court and Bankruptcy Administration Loan from the World Bank, and in cooperation with the EU and USAID, the Government is developing a modern automated court case management system for Croatian courts, both commercial and municipal. It is also training judges and developing legal information systems. Significant focus is placed also on the upgrading of the skills of bankruptcy professionals, including a regulatory framework for trustees and administrators. Also, studies aimed at improving the analytical basis for articulating a comprehensive legal/judicial reform program are components of the project.

5.59 While the strategy to reform the judiciary ought to be broad-based, in view of the concerns highlighted in this Report, much of the focus should be on the implementation of reforms required under the *acquis communautaire*. Thus, apart from broadening the efforts along the lines just described, the following actions are proposed:

- Increase the competence and efficiency of the judicial system by (a) introducing efficient court administration and court management systems; (b) introduce mandatory training for judges; (c) improve selection and appointment of judges in order to ensure that well qualified and experienced professionals are selected to serve in the judicial system and the selection process is based on a transparent merit system protected from political interference; (d) increase courts efficiency by more rational allocation of work between court personnel and modernization of case management system; (e) increase the credibility of the judicial profession

and the state prosecutors office by more stringent criteria of selection and appointment; (f) undertake a wholesale reform of civil procedure with the objective of streamlining the judicial process, limiting the right of appeal in commercial cases, and clearing the backlog of court cases; and (h) enhancing institutional independence by increasing the budgetary autonomy of the judiciary.

- Reduce backlog of cases before courts by promoting alternative dispute resolutions and out of court settlements.
- Establish the consistency of legal interpretation within the court system. Improve the system of councils of judges to issue guidelines on matters where there are variations in practice between court districts and within courts.

### ***Establishment and Protection of Property and Creditor's Rights***

5.60 **Real property.** Croatia inherited from the former Yugoslavia a land registration system which had changed little since the time of the Austro-Hungarian Empire. Since independence (and despite the availability of technical assistance funds to support improvements), little progress has been made in computerizing the land registers and reconciling them with the cadastre and the procedures required to register changes in land ownership, record liens, and settle disputes are essentially manual and extremely inefficient. In some areas, (e.g., in the Split hinterland) there is no land register at all and throughout Croatia there is a systemic problem of land without up-to-date registration information (it should be noted that this problem is at least in part driven by a desire to avoid transfer taxes). Often it is impossible to verify property ownership because the title of the current owner(s) cannot be found in a land registry. In some cases, land registries have not been maintained or have been destroyed. Even when ownership can be verified at a land registry, land transactions can be frustrated because properties often have multiple owners, all of whom need to agree on a sale or mortgage regardless of how small their share in the ownership.

5.61 The Government recognizes that the problems associated with land registries need to be resolved and has decided to implement an integrated cadastre and registration system to cover the whole country. A proposed project supported by the World Bank and other donors would cover the first five years of this comprehensive program that is expected to take 15 years to fully implement. The work during the first five years will focus on the most valuable and densely populated land areas. According to the State Geodetic Administration, if present targets are met, at the end of five years, 16 percent of the land in the country containing 50 percent of the population will be covered by the new integrated cadastre and registration system.

5.62 **Secured lending instruments and enforcement of creditors' rights.** The ability of banks to collateralize loans is limited by the ability of property owners to demonstrate good title. A long history of land transfers without registration—sometimes going back generations—means that clearing title may entail complicated and expensive searches for heirs of the original legal titleholder and complex contractual arrangements in order to

‘consolidate’ ownership in the hands of the *de facto* owner (this consolidation process also has transfer tax consequences).

**5.63 Intellectual property.** Trademarks, patents, industrial designs, semiconductor integrated circuits, and copyrights are each protected by separate laws. All of these laws are administered by the Croatian State Intellectual Property Office (CSIPO). Most of the legislation is said to be in compliance with WTO provisions and to differing degrees with EU legislation. Croatia is a member of the World Intellectual Property Organization and is a party to all international conventions dealing with the protection of intellectual property. The issue of IP rights is also addressed in the SAA and it is important that Croatia have the capacity to take effective action against the piracy and counterfeiting of IP (Article 71 of Title VI). The SAA would require a large number of changes to Croatian laws/regulations dealing with IP rights in order to adapt/harmonize them with EU laws/regulations. Four trade courts deal with the enforcement of intellectual property (IP) laws. However, given the current situation in the courts, it is not clear how readily IP rights can be enforced. Based on CSIPO’s data concerning the outcomes of enforcement actions, it would appear that the judicial system is rather ineffective in enforcing intellectual property rights.

**5.64 Movables as collateral.** There is, at present in Croatia, only a limited ability to use movable assets as collateral. The procedures to establish pledges on movable assets are formalistic and cumbersome. They can only be established through a court or a notary. Due to the restrictive legal provisions, assets such as accounts receivable and inventories cannot be used to secure loans. The biggest obstacle to developing a secured lending market for movable assets lies in the absence of a register of pledges on movables. The lack of such a national registration system exposes creditors to fraud as there is no means for even legitimate purchasers to quickly and inexpensively check title to movable property. In circumstances where large and liquid markets for stolen property exist in neighboring countries, the lack of a registry increases this risk<sup>109</sup> and discourages the development of equipment financing and other forms of movable financing. These circumstances pose particular problems for SME lending since SMEs often operate out of rented premises and most of their assets often consist of movable equipment, inventories and accounts receivable. In such cases, banks take a mortgage on the SME owner’s personal property, a prospect that may deter many would-be entrepreneurs.

**5.65** To compensate for the aforementioned deficiencies, where title to property (real or movable) is clear, lenders use fiduciary transfer of ownership/title as a means of securing debt. Based on the 1996 Law on Execution, fiduciary transfer benefits from simplified debt enforcement provisions through notaries.<sup>110</sup> While fiduciary transfer of title is widely used, it has two very negative effects on individuals and small businesses. First, in practice, property can only be leveraged once. As the bank becomes the owner of the property until the debt is paid in full, it is not possible to realize the full borrowing

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<sup>109</sup> For example, customs officers are unable to check if property is being illegally moved out of Croatia.

<sup>110</sup> Under fiduciary transfer of ownership, assets can be seized and sold using a notarial procedure which is relatively quick and efficient compared to court enforcement procedures.

capacity of capital tied up in real property by securing second or third mortgages on it. Second, fiduciary transfer of ownership effectively prevents banks from being able to offer revolving inventory loans, which are enormously important for growing SMEs as a source of working capital.

5.66 The legal process, especially court processes, make secured lending very inefficient. Croatian banks often use leasing as a means to avoid the uncertainties of title enforcement. As mentioned above, banks also frequently take fiduciary transfer of ownership of leased property and retain the title. However, particularly in the case of cars, the Ministry of the Interior (MUP) is unwilling to register the banks' ownership on car documents, which opens the door for fraudulent sales.

5.67 The lack of Croatian credit bureaus deprives banks (and businesses) of information required to make accurate credit assessments. Bank secrecy laws and a lack of interest from the largest banks presently prevent the establishment of a readily-accessible credit database.

Debt enforcement procedures are weak due to:

- (a) **the extreme slowness of court procedures;** civil procedure establishes no requirement for participants in a civil suit to present themselves prior to proceedings and offers endless opportunities for debtors to delay proceedings by unwarranted appeals.
- (b) **Lack of a functioning small claims court system; the Croatian courts are clogged with** about 1.2 million civil cases, many of which are trivial disputes and all of which are a drain on the limited resources of the court system – a small claims system exists but does not function.
- (c) **Weakness of the bankruptcy process.**<sup>111</sup> The bankruptcy law was reformed in 1998 but a functioning system has not yet emerged. The objective of the bankruptcy process should be to provide a mechanism for either the rapid restructuring of enterprise's debts and capital structure to restore economic viability or, alternatively, to provide a rapid transfer of ownership of the enterprise's assets to new owners capable of utilizing them productively. The Croatian system achieves neither of these objectives. Creditors lack control over the process and have little expectation of seeing repayment of even a portion of their debts from the bankruptcy estate within a reasonable (i.e., less than three years) timeframe. The courts and bankruptcy managers are seen as inexperienced and have a less than perfect reputation for acting in the interests of creditors rather than insiders. As with all other court procedures, bankruptcy is extremely slow – further dissipating the value of assets available to pay creditors.

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<sup>111</sup> Issues relating to bank bankruptcy are discussed below.

- (d) **Lack of certainty.** Banks express considerable frustration with the lack of consistency of legal opinion and interpretation within the court system. Differing legal rulings can be applied to contracts even within court districts and, more frequently, between court districts. This creates a lack of certainty in contracts and results in ‘jurisdiction shopping’ as creditors and debtors seek the most favorable venue for proceedings.

## Recommendations

5.68 Reform of the framework for investor and creditor rights should be one of the authorities’ highest priorities. The authorities should bear in mind that the above failures impact most heavily SMEs, which will be unable to fulfill their targeted role as the source of economic growth and employment as long as their growth is constrained by the limited availability of finance. Specifically, urgent action is required to:

- **Update and computerize the land registry, bring it into conformity with the cadastre, and make registration procedures user-friendly, cheap and efficient.** Supported by the World Bank and donors, the Government has made some progress in initiating pilot programs to improve the land registers and cadastre. The program launched in 2002 (with Bank support), calls for improvements over the next five years in real property registration systems, development of the cadastre system and improvements in information flow between cadastral and land registration offices supported by improved information technology. This first phase of the program is projected to cover about 5 percent of the country and harmonize land registration and the cadastre for about 250,000 hectares of land. Over the following 10 years, the institutional strengthening brought by work in this first phase is expected to support improvements country-wide. *In this light, the Government should seek and explore other options which might provide much faster progress in this vital area.*
- **Move ahead rapidly with the development and implementation of a registry of pledges on movable assets.** Consideration should also be given to expanding the ability to secure generally described assets and future assets, so as to allow the pledging of inventories, accounts receivables and crops.
- **Completely overhaul the debt enforcement regime.** The bankruptcy law should be reformed to give creditors real control over the process, to introduce professional and qualified bankruptcy administrators acting under the supervision of the creditor’s committee, and eliminate the ability of debtors to use the legal system to delay proceedings. These reforms should be supported by a streamlined procedure for the enforcement of unsecured debts allowing creditors to force unsecured debtors into bankruptcy and have debtors’ property liquidated quickly and efficiently. The small claims procedure should be reformed and moved outside the commercial court system to allow for very fast resolution of minor disputes and claims while allowing courts to concentrate on more serious cases.

- **Amend bank and other secrecy laws to allow the creation of public credit bureaus.** Access to such bureaus should be broadly available to businesses as well as banks. More than one experienced foreign bureau operator should be encouraged to enter the market, to promote competition and ensure first class quality of operations.
- **The State Judicial Council should commission an audit of recent commercial cases** in order to identify and deal with judges who are clearly not enforcing the law.

### *Protection of Shareholders' Rights – Corporate Governance*

5.69 In the absence of adequate arrangements for corporate governance and in the absence of a functioning market for corporate control, minority shareholders face the risk that the managers of an enterprise might expropriate all or part of their share of the profit generated by enterprise. At present, corporate governance is reported to be very weak in most employee-owned and many state-owned enterprises. Many of these are poorly managed and are loss-makers. Only in the cases of strategic investors, most notably foreign investors, and some of the PIFs, are shareholders able to protect their interests and hold enterprise management accountable for its performance. At present, minority shareholders can only hope that controlling shareholders are acting in the best interest of all shareholders. While the 1997 Law on Takeover of Joint Stock Companies supports the market for corporate control, CROSEC does not have the power to enforce it but must rely on the civil and criminal justice system to do so.

5.70 A recent review of corporate governance in Croatia assessed the legal and institutional arrangements for corporate governance in the country relative to OECD Principles of Corporate Governance and found the following weaknesses:

- (a) **Limited disclosure of ownership and control structures.** While financial information for companies listed on the ZSE is available, little ownership information is available to the public or the shareholder. Best practices in Europe require public disclosure of ownership holdings in excess of 3 percent. The minimum standard in EU countries is disclosure of all holdings in excess of 10 percent.
- (b) **Limited effectiveness of shareholder's meeting.** OECD Principle 2 provides that shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental **corporate** changes, such as (a) amendments to the governing documents of the company; (b) the authorization of additional shares; and (c) extraordinary transactions that in effect result in the sale of the company. At present, such decisions can be taken when supported by at least 75 percent of the shares represented at the shareholders' meeting. In comparison, best practice requires that such fundamental changes be put to a supermajority vote of all shares outstanding. Best practice would also set the supermajority level necessary above the average holdings of the

controlling shareholders. For example, where the mandatory free float is 25 percent, as in Croatia, the necessary supermajority would be over 75 percent in order to guarantee that the company must seek the votes of all shareholders.

- (c) **Business practices for supervisory boards.** The Company Law subjects supervisory board members to very high liability (including the possibility of imprisonment). However, there are few guidelines regarding the roles, responsibilities, operation and structure of supervisory **boards** and the qualification of board members. Of particular importance is the appointment of independent supervisory board members who may own no more than say 5 percent of the company's shares, play no role in the executive management of the company, have not worked for the company for at least two years, and are not employed by any of the company's customers or suppliers.

### **Other Recommendations**

- (a) In accordance with international best practice, the law regulating SDA should be amended to allow it to provide, on request, to any shareholder, a list of beneficial owners.
- (b) Design training programs for new supervisory board members focusing on the work, procedures and processes by which supervisory boards operate. The Chamber of Commerce could establish an institute of supervisory board members that could oversee and promote appropriate standards for corporate governance and provide training programs.
- (c) It is now best practice for companies to publish in their annual reports their level of compliance with their national standards for corporate governance. CROSEC, or the stock exchanges, might take the lead in requiring listed companies to disclose their corporate governance practices relative to a set of international best practices.

### ***Financial Disclosure, Transparency and Auditing***

5.71 The Accounting Act was amended in 1992 to require all companies to prepare IAS financial statements. In addition, the Act incorporates the balance sheet and income statement formats specified by the EU's Fourth Company Law Directive. The Audit Law requires that certified auditors licensed by the Ministry of Finance carry out all audits in accordance with IAS. CROSEC also imposes financial disclosure standards for companies issuing securities. In fact, both the ZSE and VSE impose even more stringent requirements on companies listed on Quotation I. The VSE has recently been converted from an over-the-counter market to a stock exchange and, therefore, imposes equally stringent standards for its Quotation I listings as the ZSE.

5.72 However, according to banks, their ability to lend to enterprises, particularly to SMEs, is adversely affected by the poor quality of financial information provided by

potential borrowers. It is the opinion of the banks that many company financial reports are designed to support tax returns and do not give a fair and true picture of a company's financial structure and performance. In the case of large firms, disclosure costs constrain the incentives of firms to borrow through capital markets.

5.73 Another recent review of accounting and auditing standards in Croatia focused on the strengths and weaknesses of the accounting and auditing environment as they affect the quality of enterprise financial reporting.<sup>112</sup> IAS and ISA were used as benchmarks in assessing Croatia's accounting and auditing standards. The apparent quality of financial statements examined during the review was good, but there were significant variations in the level of compliance with IAS. Financial statements are being published which do not purport to comply with IAS because compliance is not monitored or enforced. It was found that companies are required to submit different financial information at different times to different authorities and some of the information that is available to the public may not be reliable. A significant variation was also found in the quality of audits. In some cases, audits were materially affecting the clients attitudes and perceptions concerning the role of audits. There is no monitoring or enforcement of compliance with ISA. Also, since the Audit Law does not deal with regulation and supervision of the profession, there are some concerns about the issuing of audit licenses.

5.74 A National Steering Committee (NSC) was established by the Ministry of Finance (MOF) to develop a Country Action Plan (CAP) for accounting, auditing and financial reporting reforms. The CAP adopted would amend the legal framework for accounting and auditing and establish the institutional framework for revising accounting rules and regulating the auditing profession (details are presented in Woodruff (2002)). Most significantly, the Plan would (a) retain full IAS standards for financial reporting by listed companies and financial institutions; (b) in keeping with European practice, impose less stringent standards on financial reporting by SMEs; and (c) rationalize the financial reporting requirement currently imposed by several government agencies, so that each agency would receive the same information and adopt same reporting deadline. The Plan would also create a Chamber of Auditors to (a) monitor and enforce compliance with accounting and auditing laws; (b) regulate the qualifications of auditors; and revalidate the licenses of all auditors and auditing firms.

## **Recommendations**

- (a) Disclosure standards for large firms ought to be imposed regardless of the listing of a firm in capital markets.
- (b) The accounting reform agenda contained in the CAP is very ambitious and could greatly improve the credibility of enterprise financial statements. However, it remains to be determined how the regulatory expenses will be met and what sort of enforcement powers it will be allowed to exercise. This is important because the last thing the country needs is a new

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<sup>112</sup> Report on the Observance of Standards and Codes (ROSC), Croatia, Accounting and Auditing.

regulatory agency with an under-funded mandate and weak powers of enforcement.

### ***Creation of New Businesses***

5.75 In 2001, the Foreign Investment Advisory Service (FIAS) of the World Bank Group carried out a detailed study of the official procedures that must be followed to create a new business and acquire a business premises.<sup>113</sup> Following up on this Report, the Government adopted an Action Plan for Eliminating Administrative Barriers to Investments in the Republic of Croatia in February 2002 with measures derived from the recommendations proposed in the study. Four working groups were set up for the areas of investor entry into Croatia, company registration and other business establishment procedures of location and operation. Implementation of many measures set out in the Action Plan is behind schedule. The recommendations below call for the fulfillment of those measures that have not been executed, the following being the most important.

### **Recommendations**

- (a) Difficulty of ascertaining the ownership of land and property and the long procedure of owner title registration should be resolved by updating Land Book records and accelerating new owner title registration in line with the Action Plan
- (b) Adopt the Law on Physical Planning which would regulate the method of participating in the shaping of building site, stipulate the establishment and introduction of an information system for physical planning in the Republic of Croatia, amend the procedure for the issuance of location permit by adoption of appropriate plans and stipulate methods of providing utilities at the building site.
- (c) Adopt the Law on Public Utilities Management which would define time limits and provide for same conditions for connection of utilities and support solutions of the Law on Physical Planning.
- (d) Adopt the Construction Law that would define the procedures for the issuance of building permits with a special accent on the method of invitations and participation of the parties in the procedure of issuance of building permits and appeal, as well as the imposition of time limits to offices issuing certificates on the compliance of the project with special regulations and to define cases when the office does not give its opinion, regulate the area of product certification of building materials and the scope of activities and terms for accreditation of testing, controlling and certifying authorities, as well as amend the sector regulations to be in compliance with the Construction Law in the manner that the cases and structures needing a certificate are precisely defined.

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<sup>113</sup> (The report is available at [www.worldbank.hr](http://www.worldbank.hr)).

### ***Corruption***

5.76 The 2002 Business Environment and Enterprise Performance Survey (BEEPS) conducted by the World Bank and the European Bank for Reconstruction and Development showed a significant decline in the business community's perception of the level of corruption in Croatia compared to the same survey conducted in 1999. While the share of firms' annual revenue paid in bribes remained roughly unchanged, this ratio (about 0.6 percent) remained much lower than in other SEECs (about 1.7 percent). Perceptions of State Capture declined by about 20 percent between the 1999 and 2002 survey, a far more significant improvement than in the broader region. Substantially fewer firms reported to be paying kickbacks in 2002 than in 1999, and the kickbacks paid were substantially lower than the average in the region measured as a percent of contract value (about 0.9 percent in Croatia versus about 1.9 percent region-wide). In addition to a reduction in corruption, firms' perceptions of the business climate also improved significantly due to improved application of the rule of law, provision of infrastructure, an improved tax regime, and access to financing. The regulatory environment was the only part of the business climate which was perceived to have worsened (the percentage of managers' time spent dealing with authorities doubled between 1999 and 2002). Unfavorable perceptions of the judiciary remained unchanged.

### ***Winding-up Failing Businesses***

5.77 Many Croatian enterprises continue to operate while generating losses, defaulting on debts to banks, and accumulating arrears with other enterprises. The lack of restructuring is the root problem of the poor financial performance of Croatian industry. It is illustrated by a net loss of HRK8.2 billion in 1999 (roughly 5.8 percent of GDP) and ballooning enterprise arrears where over 32,000 enterprises are delinquent on their payments. Under the 1998 Bankruptcy Law, all of these enterprises are required to file for bankruptcy and managers and members of their supervisory boards can be held personally liable for any losses suffered by creditors due to any delay in filing for bankruptcy. However, as is the case with many other laws, compliance is neither monitored nor enforced and therefore non-compliance is the general rule.

5.78 While there has been some owner-led restructuring in enterprises owned by one of the PIFs,<sup>114</sup> this is seldom the case in employee-owned enterprises where managers are unable to implement restructuring measures, including cost cutting measures like labor shedding or closing loss-making operations and spinning off non-core assets to raise money to pay creditors. Given the absence of owner or manager led restructuring, the only remaining avenue would be creditor initiated restructuring through the process of bankruptcy. One of the largest creditors in the country is the BRA which has claims totaling HRK26 billion on around 700 enterprises and is the majority creditor in around 75 percent of these enterprises. At least 180 of these enterprises are already in bankruptcy but the BRA initiated none of these actions.

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<sup>114</sup> By early 2003, six out of 7 PIFs have been transformed into closed-end funds.

5.79 Under the new law on the payments system, at the end of March 2002, enterprise current accounts were transferred from FINA to the banks. Many of these accounts in the ZAP were blocked. If they remain blocked for 60 days, the law requires the banks to report this to the Tax Authority. The Tax Authority is under obligation to notify the bankruptcy court within 30 days. The court then decides with regard to all the other facts related to the company whether a proceeding will be instituted. Experience at the BRA indicates social and political considerations prevent state-owned creditors from actively pursuing their claims through bankruptcy actions. Besides, there is also the near certainty that the court system would not be able to cope with a new wave of bankruptcies. In addition to the current huge backlog of cases, there is a lack of (a) judges trained to manage bankruptcy cases; (b) experienced and trained bankruptcy administrators and trustees; (c) an effective information system for bankruptcy cases; and (d) public awareness of the concept of bankruptcy and its role in the economy.

5.80 Nonetheless, in spite of the above-mentioned shortcomings, there has been one recent high profile case where bankruptcy was quickly resolved to the satisfaction of at least some of the parties involved. This case involved Tisak, the owner of a national chain of kiosks and shops, with daily turnover reported to be over EUR1.5 million; the bankruptcy administrator was able to bring it out of bankruptcy within six months.

5.81 In general, bankruptcy cases which result in the rehabilitation of an enterprise and therefore are politically popular are likely to be resolved while resolution of cases resulting in the liquidation of an enterprise are likely to be problematic.

### **Recommendations**

5.82 Government's overall program for judicial system reform includes programs for training judges, upgrading the skills of bankruptcy administrators and installing information systems for bankruptcy cases. However, it will be some time before training programs and improved case management systems permit the courts to efficiently and effectively deal with a large number of large bankruptcy cases. It is recommended that a Council of Bankruptcy Administrators be created as a quasi-judicial body with the ability to hear evidence of malpractice and the power to suspend unscrupulous or incompetent bankruptcy administrators. It is also recommended that the BRA sell its assets to a private asset management company that will be less constrained by political considerations.

### ***Regulating Competition***

5.83 The 1995 Law on the Protection of Market Competition regulates anti-competitive behavior and the regulator is the APMC. The Agency started to operate at full capacity in February 1997. By the end of 2000, it had (a) initiated reviews of 954 agreements of which 884 reviews were completed; (b) considered 237 cases of possible abuse of market dominance, of which 150 cases were resolved; and (c) considered 128 cases of proposed actions or mergers involving the possibility of prohibited market concentration, of which 57 cases were resolved. APMC found that there were anti-competitive provisions in the Draft Law on Procurement (possible exclusion of qualified bidders), the Draft Law on Telecommunications (monopoly on fixed line service), and

the Draft Law on Auditing (provision of auditing services restricted to licensed auditors and trainees of auditing firms). Even though the courts have been largely ineffective in imposing punishment - according to the Agency - overall outcomes have been quite positive in terms of protecting market competition. In virtually all cases of abuse of dominant market position, the abuses cease as a result of the Agency's intervention. Such cases usually involve well-known enterprises that risk damage to their reputation if Agency decisions are published in the Official Gazette and then publicized by the media.

5.84 However, the APMC has been chronically understaffed and its capacity to enforce the Law has been quite limited. In addition, the already over-burdened Agency will be required to review all of the new legislation being produced in line with the SAA in order to ensure that none of it conflicts with the existing Law on the Protection of Market Competition or the draft new law. Furthermore, the APMC will also now be assigned responsibility for monitoring State aid according to the Law on State Aid adopted in 2003.

### **Recommendations**

5.85 The Agency estimates that it will need a staff of at least 46 persons in order to effectively carry out its mandate. The legal and institutional framework for preventing anti-competitive behavior is addressed in the SAA (Article 70 of Title VI). This will require that APMC deals not only with abuse of market power by dominant enterprises on the domestic market but also addresses the issue of anti-competitive behavior which affects trade between the EU and Croatia – in particular cases of state aid affecting competition in the EU.

### **D. FINANCIAL MARKETS – POLICIES FOR FINANCIAL DEEPENING AND STABILITY**

5.86 The Croatian banking system has now achieved stability after five years of intensive rehabilitation and the disappearance (at great cost to the State) of domestic private banks as a major factor in the market. However, this stability is not a sign that the banking system will now be able to prudently fulfill its full intermediation function. Rather, as mentioned, bankers identify very severe problems in the operation of the Croatian legal system which pose an obstacle to prudent lending and which may, in the medium term, lead to a significant deterioration in the system and its failure to fulfill its key role in supporting economic growth. The banks, over time, will face an increasingly difficult choice driven by the pressure of their liquidity. This choice will be between a competition-driven pursuit of—increasingly imprudent—lending opportunities in order to boost revenues or, alternatively, a steady deterioration in profitability driven by the reducing yields available from non-loan assets such as state bonds and deposits in foreign banks. There is as well an unresolved agenda on the framework for the exit of banks from the system. Unless this is resolved, the cost to the State of future interventions may compromise the fiscal strategy and also create problems associated to the loss of market discipline. Finally, this section discusses remaining steps to be taken to bring Croatian banking law and regulation into alignment with EU directives.

## Prudential Regulations for Banking Stability

5.87 The CNB recently adopted new regulations in recognition that very fast growth in lending by some banks—driven by liquidity and competitive pressures—has raised some supervisory concern, particularly given Croatia’s poor creditor framework. Such fast growth is universally recognized as one of the warning signs for future credit quality problems, particularly if the economy experiences a slowdown or recession. In response, the CNB announced in January 2003 new regulations designed to curtail credit growth by forcing banks whose stock of loans grows at a faster rate than 4 percent per quarter (16 percent per year) to place money (equal to the amount in excess of the 4 percent quarterly growth rate cap) in 90 day CNB bills with virtually no interest rate. This would represent a fairly strong financial penalty for aggressively growing banks.<sup>115 116</sup>

5.88 The “Euroization” of deposits, even if hedged by euro loans, may not suffice if Croatia were to experience massive swings in its exchange rate. A similar hedging approach proved to be ineffective in the early 1990s in the face of massive devaluation – companies were simply unable to increase foreign currency earnings at the rate required to service the amount of their debts (the dangers this mismatch can pose are highlighted by the recent experiences of Argentina, Uruguay, Turkey and Far East countries). Full portfolio hedging is not a practical possibility for a small and thinly traded currency like the kuna, and the existence of foreign currency risk in the banking system therefore highlights the need for the CNB to maintain currency stability. This may not be always possible, however, and hence one option to be considered is the adoption of prudential regulations which force foreign exchange depositors and borrowers and the banks themselves to internalize the balance sheet, liquidity and solvency risks associated with foreign exchange risk:

- Higher liquidity requirements may be imposed on foreign exchange deposits – such requirements may have to be invested in high quality foreign exchange instruments.
- Foreign exchange loans might be limited to exporters or firms/individuals capable of generating foreign exchange revenues in their regular business.
- A regulation requiring the inclusion of options in the calculation of banks’ net open foreign exchange position should be considered.

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<sup>115</sup> Since the strong growth in credit is also underpinned by a growth in foreign liabilities, the CNB has also imposed a new regulation on banks’ net open positions. From the beginning of February 2003, banks will have to maintain foreign assets to cover 35 percent of foreign exchange liabilities on a daily basis. This regulation replaces the former regulation which required a 53 percent coverage, but only on the last day of the month and thus was evaded in spirit as banks took short-term loans in the final days of the months. Since many banks will need time to comply with the new regulation the provision will be phased in.

<sup>116</sup> The new Banking Law gives the CNB the right to impose additional capital requirements and controls on banks which present a higher than normal risk profile.

## **The Framework for the Exit of Banks from the System**

5.89 Bank bankruptcy and voluntary liquidation of banks are presently governed by the bankruptcy law and the banking law. Both these frameworks have weaknesses which reduce the efficiency of the process and drive up the costs of bank exit to the State (in the role of deposit insurer):

- Bank bankruptcy is initiated by the CNB, which withdraws the bank's license and files a petition for bankruptcy with the relevant court district. At this point, deposit insurance is triggered for insured deposits and the DASB takes over the claims of insured depositors against the bankruptcy estate. The bankruptcy process itself is governed by the bankruptcy law and no special provisions apply. Bank bankruptcy is consequently subject to the same problems as regular corporate bankruptcy: a lack of creditor control over the process, extreme delays, and a failure to distribute the proceeds of liquidation to creditors.
- Voluntary liquidation offers an exit route for banks which are not viable in the long term, cannot find a merger or acquisition partner, and have positive capital. This route seems the most attractive means of exit for the group of small Croatian banks which cannot hope to compete in the medium term against the emergent national banking groups

## **Recommendations**

5.90 The passage of the new Banking Law did not result in a full reconstruction of the legal framework for the exit of banks from the system to offer creditors a significantly higher degree of protection. The following reforms should be considered for incorporation into future reforms of the Bankruptcy Law:

- Require the court to distribute all cash proceeds from liquidation within 30 days of receipt by the bankruptcy estate except for an operating reserve agreed between the bankruptcy manager and the creditor committee. If this provision is also made applicable to all banks (and companies) now in bankruptcy, the State would receive a significant dividend from the cash held by the estates of the 1999 bank failures.
- Give the creditor's committee the power to appoint and remove the bankruptcy manager and directly supervise his activities. This would be intended to give creditors greater control over the liquidation process, allow the appointment of qualified managers, and increase the transparency of the process. This should also be applicable to existing bankruptcies if possible.

## **Compliance with European Union Laws and Directives**

5.91 The CNB is engaged in an ongoing dialogue with the EU regarding compliance with specific directives and the most recent review of compliance with provisions of the SAA found no significant issues to be addressed by the authorities. The new Banking

Law has removed the obstacles to communication with EU bank supervisors previously posed by bank secrecy requirements. One important issue which needs to be addressed in the near future, however, is that the CNB presently has not yet signed the memoranda of understanding with other bank supervisors in the EU. This issue is particularly important as the Croatian banking system is now almost completely owned by EU-origin banks, and the CNB must be able to secure adequate information from foreign supervisors if it is both to fulfill its role in the consolidated supervision of the parent banks and effectively supervise their activities in Croatia.<sup>117</sup>

5.92 The CNB should therefore intensify its efforts in the short term to conclude agreements with foreign supervisors and commence a program of voluntary “quality control” inspections by EU supervisors to identify and address weaknesses which could be an impediment to consolidated supervision.

5.93 **Bank privatization.** The Government has decided that two of Croatia’s last remaining state-owned banks will be merged and subsequently privatized in stages. The postal bank (HPB) will acquire Croatia Banka (following failed efforts to privatize the latter). The Government has not yet produced a privatization plan for the merged entity. Given Croatia’s recent experience of bailing out state-owned banks who had built up portfolios dominated by non-performing loans, and given the large fiscal costs incurred in this bailout, the Government should move quickly to demonstrate its determination to get out of the business of commercial banking by quickly adopting a privatization plan for the merged bank to end the Government’s majority ownership. The authorities should then pursue this privatization without delay.

5.94 In doing so it should bear in mind the past success in seeking strategic investors who can simultaneously provide capital, business networking, technology and enhanced training capabilities (benefiting both the bank and the sector). In case privatization does not succeed, consideration may also be given to sell to private banks the assets of the banks—to be paid through the absorption of its liabilities—or, if the bank is to stay public, restrict its activities to payment services, services, small saving accounts and investment in low-risk instruments.

5.95 In recent years, a school of thought in Croatia has promoted the idea that the foreign ownership of the banking system means that there is a need to create a state-owned bank which will lend to Croatian companies. This school of thought perceives foreign banks as acquiring Croatian ones for the purpose of gathering deposits and then transferring them abroad to lend to customers in their home countries. Croatian business is thus deprived of access to credit.

5.96 While there is considerable empirical evidence to show that state banks all over the world do not serve to promote sustainable economic development but rather to divert financial resources to support unsound and politically-connected businesses, thus depriving viable businesses of finance, there is also a purely commercial answer to this

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<sup>117</sup> The CNB is now preparing to sign such memoranda of understanding with EU supervisors under the provisions of the new Banking Law.

argument. Croatia (in common with other transition countries) offers less competition and higher lending spreads than can be obtained in Western European banking markets, and thus higher returns on capital. The motivations of foreign banks in expanding into Croatia are in fact very simple: they are seeking to improve returns by lending *in* Croatia. Taking deposits at Croatia's relatively high rates and then re-lending them (at a loss) in Western markets is both commercially irrational and simply not happening – in fact the reverse phenomenon of depositors coming from neighboring countries to open accounts at higher rates in Croatian banks has begun to be observed.<sup>118</sup>

5.97 Attempting to create new or expanded state-owned commercial banks will not result in a sudden flow of credit to support growing and profitable Croatian businesses. More likely—and Croatia's very recent, and very large, bill for bailing out state-owned and politically influenced banks (including both Hrvatska Postanska Banka and Croatia Banka) should be borne in mind by the authorities—a new and large fiscal cost will be incurred through imprudent lending by new state-owned banks to unviable and politically connected businesses. In any case, the State already owns one development bank (the Croatian Bank for Reconstruction and Development – HBOR) and also provides loan guarantees to SMEs and small tradesmen through programs administered by HBOR and the Ministry of Trades and Crafts.

#### **E. ADVANCING PRIVATIZATION**

5.98 According to the Croatian Fund for Privatization (CPF), only 178 companies remain with majority state-ownership (Table 5.11) as of October 2002. However, many of these companies are both loss-making and heavily indebted. They include five shipyards, nine AKs, and a large number of hotels. In many cases, the BRA is a major creditor of the majority state-owned companies. In addition to the majority state-owned enterprises, there are 726 enterprises where the State holds stakes of 25 percent or less and 187 enterprises where the State owns between 25 and 50 percent of the shares. In February 2001, the Government adopted the program for privatizing the CPF's shares which is summarized below in Table 5.12.

5.99 Although the privatization program envisioned 10 privatization models, only two models have been widely used in practice: auctions at stock exchanges and tender sales. Shares sold at stock exchange auctions have been sold in packages the size of which depends on the dynamics at which the CPF collects consents for sale from different state institutions that own shares and on whose behalf the CPF manages those shares. Throughout 2001 and the first nine months of 2002, 754 such packages have been sold on two stock exchanges. During the same period 23 companies were directly sold to buyers through tender sales.

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<sup>118</sup> *Jutarni List* 6 February 2002.

**Table 5.11: The Remaining CPF portfolio, September 2002 (in kuna)**

Sector	Number of Enterprises	Portfolio value
Agriculture and Fishery	103	1,994,316,730
Industry and Mining	366	9,626,068,642
Construction	102	376,898,671
Wholesale and Retail Trade	189	667,987,186
Hotel Industry and Tourism	148	4,840,492,991
Transport, Storage and Communication	54	2,347,888,081
Financial intermediation	1	356,745,640
Real estate, renting business activities	89	1,902,468,581
Other	39	62,863,774
<b>TOTAL</b>	<b>1,091</b>	<b>22,175,730,296</b>

Source: CPF, Analysis of State Portfolio with Overview of Privatization Results, October 2002, p. 4.

**Table 5.12: CFP's Program for Sale of State-owned Shares**

Method for Divestiture of State-owned Shares	No. of Enterprises		
	Majority State-owned	State share: less than 25 %	State share: 25 to 50 %
A. Auctions at stock exchanges	18	281	78
B. Grants to war victims		15	1
C. Shares for restitution claims	80	339	93
D. Tender sales	50	21	4
E. Initial public offerings	12	221	14
F. Sales using advisors	21	0	1
G. Sales at discounted prices to small shareholders	19	0	2
H. Employee shareholder plans (ESOPs)	11	2	3
I. Bankruptcy	19	5	9
J. Debt for equity swaps	1	5	1
No. of enterprises in each category	142	740	163

Source: CPF.

5.100 In the past, as with the other countries of former Yugoslavia, where prior to transition enterprises were predominantly socially-owned,<sup>119</sup> the privatization process undertaken by Croatia gave overwhelming preference to manager and employee buy-outs. This mode of privatization has not been conducive to enterprise restructuring, and has discouraged foreign investment. The dominance of these large enterprises in a non-competitive environment has also discouraged the emergence of small and medium enterprises. Another adverse side effect of the privatization strategy was the limited use of capital markets for divestment of state assets.

<sup>119</sup> See Slovenia: Economic Transformation and EU Accession, the World Bank, 1999, Chapter VI, for a description of socially-owned enterprises.

5.101 Large enterprises, with insider owners, such as the privatized *agro-kombinats* (AKs) were able to mobilize strong political support in opposition to any take-over bid by a strategic investor. In the case of the privatized AKs, a contestable market for corporate control is particularly important since the present ownership is unlikely to undertake necessary restructuring measures, including labor shedding, closure of loss-making business units, and unbundling into separate companies, each with an identifiable core business. Some state-owned enterprises continue to claim and receive preferential treatment while generating large losses, avoiding hard budget constraints and escaping bankruptcy proceedings. Preferential treatment includes the consolidation programs for the AKs and the rehabilitation programs for the shipyards.

5.102 Croatia's privatization strategy has both strengths and weaknesses. The weaknesses arise primarily from the ongoing pressures to restructure before privatizing which is a virtual guarantee of new losses. The strengths arise mostly from the privatization of utilities, banks, insurance company which are targeting strategic investors and which intend to make more use of domestic capital markets thus fostering its development.

5.103 According to CPF, many loss-making enterprises will need to be restructured prior to being offered for sale to strategic investors. In the meantime, losses and arrears continue to accumulate. The alternative of privatizing the assets of some of these enterprises through bankruptcy merits serious consideration. In the case of the Sisak steel mill, it took only six months for the bankruptcy manager to transfer ownership of the assets to foreign strategic investors. But unless there is a dramatic increase in the capacity of the courts to handle bankruptcy cases, by the time final ownership of the assets of the majority state-owned enterprises is resolved, the assets themselves may be fully depreciated.

5.104 On the positive side, the Croatian Government has moved aggressively with the privatization of utilities and INA. It approved plans in March 2002 to sell up to 25 percent plus 1 share of the INA parent company to a strategic investor later in the year. This may be followed by the flotation of at least a further 15 percent on the Zagreb stock exchange. The State expects to retain ownership of at least a 25 percent stake plus 1 share until Croatia enters the EU. Privatization is also expected to include the sale of at least 15 percent of INA's shares by way of a public offering to Croatian citizens and companies, as well as foreign investors. In addition, similarly to the transfer of shares proposed for HEP, up to 7 percent of the shares are expected to be sold to present and former employees of the companies within the INA Group, and 7 percent of the shares should be transferred, without compensation, to Croatian war veterans and members of their families. A number of shares may also be taken as compensation to the former owners. Finally, there are plans to look for strategic partners for the sale or swap of the remaining shares, the decision relying on the Government subject to consent of the Parliament.

## Recommendations

5.105 Advancing in the privatization agenda would contribute importantly to enterprise restructuring and economic growth in Croatia. The following recommendations will help to accelerate restructuring and improve the effectiveness of privatization:

- Review of privatization transactions involving fraud to ensure clear legal rules and effective monitoring of future transactions. A positive step in that direction, reflecting the increased interest in this question, was the establishment of the Corporate Governance Council within the Croatian Employers' Association, in the autumn of 2000. This consultative task force was involved in the preparation of the new legislation in that domain and also adopted the first Croatian Corporate Governance Code at the end of 2001.
- Strengthening corporate governance and control of business performance of enterprises through empowerment of crucial capital market institutions and adopting crucial principles of corporate behavior based on the best practices and rules of the EU countries and OECD Corporate Governance Principles and Codes. These reforms should be strictly applied to SOEs and privatized firms.
- Abandoning the practice of bailing out companies at the tax payers' expense through subsidies from the budget, writing off debts to the State, tax breaks, exemption of payment of pension and health insurance contributions, and other forms of behavior which relieve corporate management of its responsibility;
- Easing of legislation regulating the company's exit from the market (winding up and bankruptcy) in the case of losses; this can be achieved through a stricter implementation and amendments to the present Law on Bankruptcy that would strengthen the capacity, authority and efficiency of Bankruptcy Courts.
- Parallel reform of the judicial system, resolute sanctioning of corruption, violation of ownership rights and other norms in the process of privatization, strengthening business and professional ethics, increase the level of transparency and accountability of government administration.
- Prioritizing strategic investors that can transfer organizational, marketing and technological know-how as well as fresh capital in the process of privatization.
- Minimize restructuring prior to privatization – the State knows less how to do it anyway.
- Broaden opportunities arising from the privatization of SOEs to force listing of these companies through public offerings of minority stakes.

## **6. STRENGTHENING THE LEGAL AND REGULATORY FRAMEWORK FOR EFFICIENT LABOR MARKETS**

6.1 Croatia's integration in European markets will create strong competitive pressures in the enterprise sector. The ensuing process of adjustment may involve a massive reallocation of labor across and within sectors as well as changes in the skills required at occupational levels as diverse as blue and white collar workers to professionals, civil servants and entrepreneurs. Inevitably, this will require the destruction of jobs and the creation of new ones. In that environment, inefficient labor markets, i.e., institutional rigidities and skills mismatches that do not permit a smooth reallocation of labor resources from loss making to more productive and profitable firms - can cause high and persistent unemployment. Workers without adequate skills and particularly those without the ability to acquire needed skills are not only going to enlarge the pool of the long-term unemployed but will also limit the potential for enterprise restructuring and innovation-driven growth. The strategy for education is thus an integral part of the social and growth strategies.

6.2 In contrast with these needs, Croatia's economy is characterized by high unemployment and limited job flows. The pace of job creation in Croatia has been slow due to a number of factors, including a rigid labor market. Extremely strict employment protection legislation, which limits labor turnover, and relatively high unit labor costs, which discourage hiring and investment are some of the key labor rigidities. High unit labor costs reflect a strong bargaining power of insiders—workers with protected jobs—and the predominance of industry level bargaining, which generates wage pressures. Thus, faster job creation, necessary to reduce unemployment, calls for labor market liberalization with the aim of lowering hiring and firing costs. This clearly needs to be complemented with all the reforms which will facilitate enterprise restructuring, new jobs creation and the financing of new investment.

6.3 The other pillar of the growth strategy proposed is the need to upgrade educational standards as well as technological and organizational standards that will permit Croatian firms to compete in European markets. This requires revising the role of the State in education. Given the nature of the market failures in education, the State clearly has financing, regulatory, and information-providing roles. If it is assumed that all levels of education generate some positive externalities for the collectivity, the State has a *financing role* at all levels. However, regardless of level, there is no theoretical reason to finance education for all families - only for those for whom having to pay reduces their consumption of education below the socially desired level. The State has a *regulatory role* to assure that providers, whether the State, local communities or private providers, meet certain standards, such as safety, quality, and tolerance standards. And it also has an *information-providing role* to help consumers make informed choices among alternative providers, to help providers improve their performance, and to create a basis for holding

providers accountable for their performance. The overall government strategy requires a shift from a supply-driven to a demand-driven system of education, training, and research. It implies an education and training system that is less institution-focused and more a network of learning opportunities accessible to individuals of all ages. This requires in turn granting more flexibility to universities to adapt to change.

6.4 The Government should also play a key role in R&D. Individual companies may not have incentives to invest in basic research because the regulatory framework does not allow the investor to capture all the benefits from it. Thus, the State should focus its direct R&D investments on basic research. The other key R&D role for the State is creating a positive institutional environment for companies to invest in R&D. An evaluation of corporate impediments to investing in R&D is needed. The evaluation should identify government actions that can create a positive institutional environment, e.g., easing the patent application process, enforcing patents, protecting intellectual property rights, or using tax policy to create fiscal incentives for firms to invest in R&D.

6.5 The chapter first reviews labor market developments focusing on the stagnant character of the Croatian labor market and the factors that hinder job destruction and job creation. It then evaluates legal and institutional issues regarding flexibility of the labor market; it focuses on labor law reforms in Croatia including those that would be required to adopt the *acquis communautaire*. The rest of the chapter is devoted to the education strategy.

## A. LABOR MARKETS

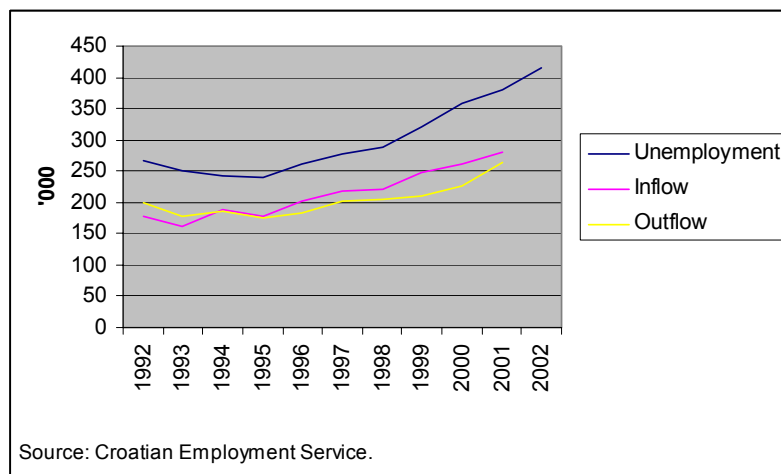
### Background

6.6 With an unemployment rate of 15.2 percent<sup>120</sup>—56.7 percent unemployed for over one year—and a labor force participation rate of 50.9 percent, Croatia has one of the lowest employment-to-population ratios: only 43.1 percent of persons of working age (aged 15 or more) are employed in Croatia. This entails a low level of the utilization of labor resources and translates in the lower level of output and economic welfare. The gradual increase in (registered) unemployment stock started in 1996—when the inflow into the pool of unemployed began to exceed the outflow from unemployment—and accelerated after 1998 (Figure 6.1).<sup>121</sup>

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<sup>120</sup> There is a discrepancy between unemployment data coming from the unemployment register and from the Labor Force Survey. As many as 42.3 percent of all persons who are registered at Employment Offices are *not* unemployed according to the ILO definition of unemployment. They either have a job (in the informal sector), or are not actively looking for work, or are not available for work. The genuinely unemployed as a rule register at Employment Offices; only 14.4 percent of the job seekers do not register, and this group is likely to include mainly persons whose unemployment is still short-term or transient. The net effect is thus that the unemployment register data significantly overestimate the level of unemployment (by nearly 50 percent).

<sup>121</sup> Data used to calculate the unemployment rate (shown Income from the Labor Force Survey (LFS), which applies the standard ILO definition of unemployment. Data on the dynamics of unemployment

**Figure 6.1: The Evolution of Registered Unemployment, 1992 - 2002**

6.7 The low employment-to-population ratio—a key indicator of labor market performance—is a result of key factors that distinguish Croatia from an average OECD country. These are the extremely high youth unemployment (36.6 percent); the low labor force participation of young persons (aged 15-24); and the relatively low labor force participation of prime-age men (aged 25-49) and of older persons (aged 50 or more). The overall low labor force participation reflects poor availability of job opportunities and is associated with the so-called “discouraged worker” effect, i.e., workers cease their job search effort because their earlier attempts to find work have proved futile.

6.8 These characteristics of the labor market are quite typical of other transition economies with inflexible labor markets. At the same time, they are in sharp contrast to those prevailing in transition economies with more flexible labor markets, such as Hungary or Estonia.

6.9 The low employment-to-population ratio in Croatia is, as in many CEECs, a result of a mode of labor market adjustment to numerous supply and demand “shocks” in which the brunt of adjustment has been born by employment rather than wages. Employment has declined while—once the growth of output has resumed—wages have roughly followed productivity increases. Since 1995, employment has declined by a few percent, while real wages have grown by about one-third alongside productivity (in industry). Much of the productivity achievements were due to labor shedding. For many firms, especially the privatized ones, downsizing has become a prerequisite for survival in a more competitive environment. To illustrate this process, an average firm size has almost halved during the transition in Croatia, decreasing from over 22 employees in 1993 to about 12 employees in 2000. Labor shedding has led to improved productivity and lower costs, but also, given limited job creation, has contributed to unemployment.

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(Figure 6.1) come from the unemployment register and are not comparable with the LFS data. The description of both sources of unemployment data is provided in Box 1.

6.10 Enterprise restructuring has given rise to accelerated inflows into unemployment, a process which began in the mid-1990s in Croatia (Table 6.1). This has been reflected in an increasing proportion of workers who were laid-off among the unemployed and, correspondingly, in a decreasing proportion of workers without previous labor market experience (whose share in unemployment was disproportionately large at an early stage of the transition in Croatia). At the same time, outflows from unemployment, including outflows to jobs, have slowed down, and presently fall short of inflows into unemployment. For example, in 2001, as much as 74,000 persons newly registered at the Employment Offices, while 70,000 were de-registered, of which only less than 40,000 reportedly found jobs. Since the excess of inflows into unemployment over outflows from unemployment has persisted, the result has been a gradual build-up of unemployment – from 240,000 in 1995 to 410,000 in early 2002.

**Table 6.1 Registered Unemployment, 1992-2002**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Unemployment ('000)	266.6	250.8	243.3	240.6	261	277.7	287.8	321.9	357.9	380.2	389.7
	Percentage of unemployment stock										
Women	53.0	55.2	53.6	51.6	49.7	49.4	51.9	52.5	52.7	53.5	54.6
No labor market experience	29.8	32.0	34.2	35.1	33.6	32.2	31.4	29.4	28.2	27.4	25.9
Recipients of UB	22.1	10.1	12.5	15.0	20.3	19.9	15.6	16.9	17.7	18.5	20.7
Inflow (newly registered)	66.9	64.1	77.2	73.6	77.9	78.9	76.9	77.4	73.2	73.9	66.5
Outflow to jobs	75.3	71.3	76.6	73.0	70.2	72.5	71.5	65.2	62.9	69.5	73.9
removed from register	30.0	29.1	35.2	31.5	35.7	36.7	38.0	32.8	33.0	38.8	42.5
Unemployment-to-Vacancies ratio	45.3	42.1	41.4	41.4	34.5	35.8	33.6	32.4	29.9	30.8	31.4
	2.0	1.8	1.6	1.9	2.1	2.2	2.2	2.4	2.4	1.9	2.2

*Source:* Monthly Statistics Bulletin 3/2002, Croatian Employment Service, author's calculations.

6.11 Relatively few unemployed receive unemployment benefits. The benefit coverage rate has been below 20 percent since the mid-1990s. And the benefit replacement rate (i.e., benefit/earnings ratio) is low, as unemployment benefit accounts for only about one-fourth of the average wage. All these factors—the low replacement rate, relatively short duration of the benefit, and limited coverage—imply that labor supply disincentives are modest and thus the unemployment benefit system is unlikely to have much influence on the level of unemployment in Croatia. Most importantly, low benefit coverage implies that the role of existing labor supply disincentives is limited as few people are affected by them.

6.12 Surprisingly, the unemployment-to-vacancies (U/V) ratio has somewhat improved over the recent period, and is quite favorable at 1.9 (meaning that there are less than two unemployed per one vacancy). The relatively large number of vacancies suggests a structural component of unemployment in Croatia. For example, unfilled job vacancies are likely to indicate that the unemployed have different skills than those required in vacant jobs. However, better data and further research are necessary to find out to what extent unemployment in Croatia has a structural character.

6.13 In an efficient economy with a flexible labor market job creation goes hand in hand with job destruction, with new expanding firms absorbing labor released in the old and declining firms. Hence, the relevant question is what limits the job creation potential of the Croatian economy? Why does the Croatian economy not generate a sufficient number of jobs to offset the negative impact of enterprise restructuring?

### The Challenge of Job Creation

6.14 Declining employment and rising unemployment mean that job creation in Croatia falls short of job destruction. The source of the employment problem in Croatia is *not* high job destruction, it is low job creation (Table 6.2). The job creation rate in Croatia is only 3.5 percent, compared with almost 10 percent in Lithuania or 7 percent in Bulgaria. This means that Croatia creates less than half as many jobs (relative to its employment) as more dynamic transition economies. In other words, Croatia needs to at least double its rate of job creation to achieve a degree of restructuring similar to that in other transition and market economies. The rate of job destruction in Croatia is much lower than in other transition economies, and even lower than in mature market economies, such as Germany and France. Despite the very low rate of job destruction, employment decreased in Croatia because the rate of job creation is even lower. Thus, the key to reduce unemployment is not to protect old jobs, but to foster the creation of new jobs.

**Table 6.2: Job Creation and Job Destruction: Croatia Against Selected Countries (as % of Total Employment)**

	Croatia	Bulgaria	Lithuania	Poland	France	Germany
	2001	2000	1998-99	1998-99	1984-91	1983-90
Job creation	3.5	6.8	9.7	5.3	6.6	6.5
Job destruction	4.9	10.8	10.7	10.1	6.3	5.6
Employment growth <sup>a/</sup>	-1.4	-4.1	-0.9	-4.8	0.3	0.9
Job turnover	8.4	17.6	20.4	15.4	12.9	12.1
Job reallocation	7.0	13.5	19.4	10.5	12.6	11.2

a/ The employment growth rate refers to the sample and is not necessarily consistent with the overall change in employment.

Note: Continuing establishment only (i.e., business start-ups and closures are not included).

Source: Croatia: Central Bureau of Statistics, author's calculations; Bulgaria: Rutkowski (2002b); Lithuania: Rutkowski (2002a); Poland: Rutkowski (2001); OECD countries: OECD (1996).

6.15 Why is job creation relatively low? Barriers to *entry* of new firms and barriers to *expansion* of employment in existing firms is the most direct response. These barriers in turn can be traced back to an unfavorable investment climate, labor market rigidities, high labor costs and an inflexible wage structure. In addition, new jobs created are likely to differ in salient characteristics from old jobs destroyed. This may make the transition from old to new jobs costly and may contribute to structural unemployment through skill and spatial mismatches.

6.16 Business start-ups create about one-third of new jobs in the economy, a regularity observed in a number of transition economies, such as Bulgaria, Lithuania and Poland

(Rutkowski 2001b, 2002a, 2002b). At the same time, firm density in transition economies tends to be less than in mature market economies. Thus, a major challenge of the transition is to encourage firm entry in order to increase firm density and thus the number of available jobs. This involves a important structural change: a transition from a relatively small number of large (publicly owned) firms toward a much larger number of smaller, private firms. This process of growing number of small private firms is already under way in Croatia. It is accompanied by the closure of inefficient firms, especially after 1997. As a result, the growth in the overall number of firms has been wobbling. The rate of new enterprise growth was insufficient to offset the employment reductions taking place in existing firms. In other transition economies, the process of new firms' formation has been much more dynamic than in Croatia. For example, in Poland the number of firms increased by some 80 percent over the period 1995-2000, implying an average annual rate of growth of almost 13 percent, which is much higher than in Croatia.

6.17 Although small enterprises' share of employment has risen in Croatia, it is still relatively low. Small enterprises (employing fewer than 50 workers), which are a proxy for the "new sector" account for about 46 percent of total employment. This means that the new sector is still underdeveloped in Croatia, with important implications for economic and employment growth. As noted in World Bank (2002), "[...] there appears to be a threshold – of around 40 percent for the shares of small enterprises in employment and value added – below which economies do not take off in terms of growth." (p. 40). Croatia has barely passed this threshold, and is lagging behind leading reformers where the share of employment in small enterprises is over 50 percent. This means that the new sector, comprised of small private firms, needs to grow further and faster in order to enhance the job creation potential of the Croatian economy.

6.18 The economic costs of low job flows (turnover) can be substantial. Limited job turnover (which is the sum of job creation and job destruction) implies that there are limited efficiency gains associated with reallocation of jobs away from less productive toward more productive uses. Low job turnover entails less enterprise restructuring and less associated productivity improvements. In Croatia, only 7 percent of all jobs are annually reallocated from contracting firms toward expanding firms. This is much less than in the restructuring transition economies and less than in mature market economies. For example, in Lithuania, the job reallocation rate accounts for over 19 percent and in Bulgaria for close to 14 percent.

6.19 In short, job destruction is low in Croatia, but so is, and not independently, job creation. This limited job turnover implies a slower reallocation of resources, including labor, away from less productive uses toward more productive uses. The cost of the delayed restructuring is lower than otherwise possible productivity and long-term output growth.

6.20 Although the overall job turnover rate is low in Croatia, there are some sectors of the economy which are more dynamic than others. Notably, small firms and private firms create, as well as destroy, more jobs than larger firms and state-owned firms (Rutkowski, 2002). The job creation rate in the private sector at about 6 percent is nearly three times as in the SOE sector. However, the job destruction rate in the private sector is also much

higher (7 and 2 percent respectively). And even the more dynamic segments of the Croatian economy are far less dynamic to similar sectors in other dynamic transition economies. This means that institutional barriers to job creation are pervasive, and not limited to particular segments of the economy (e.g. to the SOE sector). While the governance factor can contribute to the slow pace of restructuring in SOEs, it seems that it is mainly institutions and regulations that hinder restructuring in the private sector. Analysis at the regional level (Rutkowski, 2002) shows that the labor market is stagnant across the country in Croatia, i.e., there are no regions with high job turnover and large job reallocation. The main problem is still low job creation across the country, not high job destruction. Given the private sector's dynamic potential, *the best way to foster job creation is thus to remove institutional and regulatory constraints on its development.*

6.21 Other than the institutional constraints that may hinder job and firm creation, there is evidence (Rutkowski, 2002) that the main factors that contribute to firm employment growth in Croatia include high productivity and low unit labor costs, high capital intensity and investment and export orientation. These findings have straightforward policy implications. Employment growth will be fostered by policies that promote competition and thereby force firms to improve productivity, policies which help firms to lower costs (e.g., through lower taxation), policies which improve access to credit, facilitate investment and export. In short, a key for faster job creation is better investment climate.

### **Legal and Institutional Factors Behind a Stagnant Labor Market**

6.22 The conditions to develop a favorable business environment have been discussed in the previous chapter. Labor institutions and legislation are a crucial component of the business environment. What is the impact of employment protection legislation on labor market dynamics? And how do labor costs, wage flexibility, and skills mismatch influence new employment? These issues are examined below.

#### ***Stringent Employment Protection Legislation***

6.23 Croatia has one of the strictest employment protection regulations in Europe and among the OECD countries.<sup>122</sup> Laying-off redundant workers is difficult and costly due to both high procedural and monetary costs of dismissals. This highly rigid nature of the Croatian labor market is reflected in a high value of a composite index of the strictness of employment protection legislation (EPL) developed by the OECD.<sup>123</sup> Table 6.3 documents that employment protection legislation is stricter in Croatia than in any

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<sup>122</sup> Labor laws and regulations in Croatia are discussed in the following section.

<sup>123</sup> The index is a weighted average of 22 indicators of the strictness of employment protection legislation in three areas: (1) regular contracts (with the weight of 5/12); (2) temporary contracts (5/12); and (3) collective dismissals (2/12). Regular contract are divided into (a) procedural inconveniences (1/3); (b) notice and severance pay (1/3); and (c) difficulty of dismissal (1/3). Temporary contracts include: (a) fixed term contracts (1/2) and (b) temporary work agency employment (1/2). The index for collective dismissals is directly computed by averaging four indicators relating to special requirements and costs associated with collective dismissals. The higher the value of the summary index, the stricter the employment protection legislation. The methodology of calculation of the index is described in OECD (1999).

transition economy accessing EU and stricter than in virtually all EU and OECD economies. It is noteworthy that EPL in Croatia is much stricter than in countries characterized by low unemployment and flexible labor markets, such as Hungary, Denmark, Ireland, the Netherlands, and the U.K. For example, the summary EPL index was 1.1 in Ireland and 1.7 in Hungary, compared with 3.6 in Croatia. This illustrates how strict employment protection may not prevent high unemployment and how, to the contrary, more flexible labor markets may.

**Table 6.3: Employment Protection Legislation Strictness for Croatia and Central and East European EU accession countries (CEEEUAC)**

Country	EPL Strictness			Summary Index
	Regular Employment	Temporary Employment	Collective Dismissals	
Croatia	2.8	3.9	5.0	3.6
Czech Republic	2.8	0.5	4.3	2.1
Estonia	3.1	1.4	4.1	2.6
Hungary	2.1	0.6	3.4	1.7
Poland	2.2	1.0	3.9	2.0
Slovak Republic	2.6	1.4	4.4	2.4
Slovenia	3.4	2.4	4.8	3.5
CEEEUAC average	2.7	1.2	4.1	2.4
EU average	2.4	2.1	3.2	2.4
OECD average	2	1.7	2.9	2.0
CEEEUAC minimum	2.1	0.5	3.4	1.7
EU minimum	0.8	0.3	2.1	0.9
OECD minimum	0.2	0.3	0.4	0.7

*Source:* OECD (1999), World Bank estimates for Estonia and Slovenia, Biondić et al., (2002) for Croatia.

6.24 The overall high level of EPL in Croatia reflects regulatory constraints in three basic areas: high procedural and monetary costs associated with individual dismissals, restrictions on temporary employment, and high costs of collective dismissals. In all three cases, regulations in Croatia are more stringent than in the vast majority of transition economies, the EU and the OECD. In particular, the index for collective dismissals—which can involve as few as five workers—reaches the maximum absolute level of 5 in Croatia, higher than in all the CEECs considered, and the level of the index of strictness for temporary employment is three times higher than the average of the CEECs in the table.

6.25 *Individual dismissals* are costly due to the long advanced notice period and high severance pay. Specifically, advanced notice of dismissal for workers with 20 or more years of service is six months in Croatia, compared with three months in Hungary or Poland and two months in Ireland or the Slovak Republic. Severance pay is determined as two weeks of salary per year of service, with no upper limit, which is very generous. For example, a Croatian worker with 20 years of service would be entitled to 10 monthly

salaries in severance pay, while his/her Slovak, Irish and Hungarian colleagues would get two, 2.2 and five monthly salaries, respectively. Firing workers can be quite expensive also because courts traditionally have exhibited a pro labor bias which makes it difficult to prove poor performance. Thus, often the courts order job readmission and compensation amounting to forgone earnings (with no upper limit).

6.26 *Temporary (fixed-term) employment* is a way of circumventing high costs of terminating regular employment contracts. However, the law in Croatia restricts its use by requiring that temporary contracts are signed only on an exceptional basis when there is a valid and important reason.<sup>124</sup> Furthermore, the total cumulative duration of temporary employment cannot exceed three years, compared to five years in Hungary or Estonia. Another way of lowering employment costs is hiring labor through Temporary Work Agencies. Such agencies operate in most transition and OECD countries but do not exist in Croatia (due to lack of adequate regulations). The result is a relatively low incidence of temporary contracts – 11 percent in Croatia. For comparison, in Spain, where temporary contracts were introduced specifically to improve flexibility and increase hiring, they account for about one-third of all contracts (Dolado et al., 2002). However, despite the restrictions, temporary contracts seem to be increasingly used by Croatian employers. According to the recent Labor Force Survey (2001) the incidence of temporary employment contracts among new hires was 55 percent.

6.27 If individual dismissals are difficult, *collective dismissals* are even more difficult implying that lay-offs for economic or technological reasons are very costly. One source of the problem is an overly inclusive definition of collective redundancy in Croatia whereby special regulations apply from five dismissals over the period of 6 months upward. This is a much broader definition than in the EU, where collective redundancy is defined as either 10 or more workers laid off over the period of one month, or 20 or more workers laid off over the period of three months.<sup>125</sup> Another source of the high costs of collective dismissals is the strict procedural requirement. They include consultation with trade unions on alternatives to redundancy, notification of the local Employment Office and an obligation to prepare a Social Plan to mitigate the effects of redundancy. These procedural requirements involve an additional delay before a notice of dismissal can be issued, which amounts to 90 days in Croatia, compared to four to six weeks in other countries. The procedural costs of collective dismissals seem particularly high for SMEs which have less resources to comply with all the requirements.

6.28 Stringent employment protection regulations and high firing costs contribute to and account for the observed labor market outcomes, such as low job creation and hiring, long duration of unemployment spells and low escape rate from unemployment, and the concentration of unemployment among disadvantaged worker groups.<sup>126</sup> On the one

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<sup>124</sup> Valid reasons include seasonal work, replacement of a temporary absent employee, special business needs, etc.

<sup>125</sup> European Council Directive 98/59/EC. See Fuenzalida 2002 for the comparison of employment protection in Croatia with EU norms.

<sup>126</sup> It has been extensively documented that the costs of labor market rigidities and poor labor market performance are disproportionately borne by vulnerable worker groups, such as youth, women and older

hand, stringent labor market regulations discourage firm entry (Scarpetta, 2002). On the other hand, high firing costs discourage hiring as employers limit staff recruitment in order to avoid future costs of employment adjustment to changes in product demand (OECD 1994). Accordingly, limited hiring is a mirror image of limited firing. By hindering both job destruction and job creation strict EPL limits job turnover. As a result, both employment and unemployment spells tend to be longer. Chances to escape unemployment are thus less than in a dynamic, high turnover labor market. This, coupled with the discouraged worker effect, leads to lower employment-to-population ratio, especially among disadvantaged worker groups, such as youth, women and older workers, and thus to the underutilization of labor resources (OECD 1999).

### ***High Labor Costs***

6.29 High wages—adjusted for productivity—is another potential impediment to new labor hires. Wages are high in Croatia, higher than virtually all other transition economies of Central and Eastern Europe (Rutkowski, 2002). An average manufacturing worker received in 2000 close to US\$500 in Croatia, which is from 50 to 100 percent higher than in Croatia's closest competitors such as the Czech Republic (US\$340), Hungary (US\$310) or the Slovak Republic (US\$260) and almost five times as much as in Bulgaria or Romania (US\$110). Relatively high wages are not compensated by proportionately higher labor productivity. Using GNI per capita as a proxy for labor productivity, it turns out that wage differentials between Croatia and other transition economies are larger than productivity differentials (Table 6.4).<sup>127</sup> In other words, productivity adjusted wages are high in Croatia compared with other countries. For example, manufacturing wages in Slovenia are about 60 percent higher than Croatia, however, productivity is over twice as high, which implies that despite higher wages, unit labor costs are lower in Slovenia. Similarly, while labor productivity in Hungary is at a similar level as in Croatia, Hungarian wages are on average one-third lower.

6.30 Labor costs comprise not only gross worker wages but also payroll taxes paid by the employer. The payroll tax rate for employers, at around 18 percent, is lower in Croatia than in other transition economies of CEECs and in fact lower than in most EU countries. The total payroll tax rate in Croatia is 37.6. By way of comparison, the payroll tax rate in EU accession countries ranges from 33 percent in Estonia to 50 percent in the Slovak Republic. The average payroll tax rate in the EU is 23.5 percent (Riboud et al., 2002). The low payroll tax rate in Croatia is a positive factor, as high payroll taxes increase the cost of labor and thus negatively affect labor demand. Nonetheless, the relatively low payroll tax rate in Croatia does *not* offset relatively high gross wages. Total labor costs in Croatia are still higher than in most of its East European competitors. For example, labor costs in Croatia's manufacturing are about 15 percent higher than in the Czech Republic (whose GNI per capita is higher than in Croatia), 30 percent higher than

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individuals. See Bertola et al. (2002) for most recent research on the relationship between labor market institutions and demographic employment patterns.

<sup>127</sup> Clearly, GNI per capita is a very rough proxy for manufacturing productivity (output per worker). Nonetheless, given cross-country correlation between GNI per capita and productivity, the scope for large errors regarding the ranking of countries with respect unit labor costs seems limited.

in Hungary (about the same GNI per capita as Croatia), and 50 percent higher than in the Slovak Republic (whose GNI is just 20 percent lower than in Croatia).

**Table 6.4: Gross Monthly Wages in Manufacturing, 2000**

	Gross wages	Labor compensation a/	GNI per capita	Gross wages	GNI per capita
		\$		Croatia = 100	
Bulgaria	109		1520	22	33
Croatia	494	577.9	4620	100	100
Czech Republic	341	503.5	5250	69	114
Estonia	281	373.3	3580	57	77
Greece	1432	..	11960	290	259
Hungary	312	449.7	4710	63	102
Ireland	1804	..	22660	365	490
Latvia	225	..	2920	46	63
Lithuania	247	..	2930	50	63
Poland	457	605.3	4190	92	91
Portugal	679	..	11120	138	241
Romania	112	..	1670	23	36
Slovak Republic	255	382.2	3700	52	80
Slovenia	793	1093.9	10050	160	218
Spain	1461	..	15080	296	326

= Not available.

a/ Gross wage plus payroll taxes.

Source: Wages: Yearbook of Labor Statistics 2001, ILO; Gross National Income: World Bank Atlas, 2002; Exchange rate: World Development Indicators, The World Bank, 2002.

6.31 **Digression.** Payroll taxes are not a good measure of the tax wedge between labor costs to the employer and net take-home pay to the employee. This is due to the fact that contributions (e.g., to social security) can be shifted from employers to employees without affecting the level of labor costs. For example, in Croatia, while social security contributions paid by employers are relatively low, those paid by employees are relatively high, accounting for the high gross wages. The current tax wedge accounts for 41.3 percent of total labor costs in Croatia (Table 6.5), which is relatively low both by standards of EU and other transition economies of CEECs. For example, in CEECs, the tax wedge ranged (in 2000) from 44.4 percent in the Slovak Republic to 45.3 percent in Poland, to 56.3 percent in Hungary (OECD 2001). In the EU, the tax wedge ranges from 39.4 percent in the U.K. to 67 percent in Belgium, with the average (unweighted) at 52.7 percent.<sup>128</sup> The relatively low tax wedge is a result of a conscientious effort of the Government of Croatia, who recognizing the importance of low labor costs for Croatia's competitiveness and employment, reduced the tax wedge by a considerable 7 percentage points in the second half of the 1990s.

<sup>128</sup> The tax wedge is calculated for a single individual at the income level of the average production worker.

**Table 6.5: The Changing Structure of Labor Costs**

	1995	2000	2002 <sup>c/</sup>	2003
1 Employee gross wage	100	100	100	100
2 Employer contributions (payroll taxes) <sup>a/</sup>	21.78	16.98	17.92	17.2
2.1 Health insurance	7	7	7	15.0
2.2 Professional disease	0	0	0.47	0.5
2.3 Pension insurance	12.75	8.75	8.75	0.0
2.4 Unemployment insurance	0.85	0.85	1.7	1.7
2.5 Water contribution	0.8	0	0	0.0
2.6 Chamber of commerce contribution	0.38	0.38	0	0.0
3 Employee taxes and contributions <sup>a/</sup>	37.00	31.69	30.74	..
3.1 Health insurance	7.0	9.0	9.0	0.0
3.2 Pension insurance	12.75	10.75	10.75	20.0
3.3 Child allowance contribution	2.2	0	0	0.0
3.4 Unemployment insurance	0.85	0.85	0	0.0
3.5 Personal income tax (effective)	14.2	11.1	11.0	..
4 Net (take-home) wage (1) - (3)	63.00	68.31	69.26	..
5 Labor costs (1) + (2)	121.78	116.98	117.92	117.2
6 Tax wedge b/ $[(5)-(4)]/(5)*100$	48.27	41.60	41.26	..

a/ As a percentage of employee gross wage.

b/ As a percentage of labor cost.

c/ As of November 2002.

Source: Ministry of Finance; Bank staff calculations.

6.32 Why are unit labor costs (its proxy the ratio of labor costs/GNI per capita) high in Croatia?<sup>129</sup> Given that the tax wedge is moderate, it is workers take home pay that is the primary reason of high unit labor costs. One possible factor behind relatively high wages is wage pressure exerted by *insiders*, that is the workers with secure jobs who therefore have a strong bargaining position. In addition, the industry level bargaining which prevails in Croatia (especially in large firms) has likely contributed to increase labor costs.<sup>130</sup> The strong real wage growth, unparalleled in other transition economies, which has occurred in Croatia since the mid-1990s, is consistent with both hypothesis. If so, then high unit labor costs in Croatia result from the interaction between the strict EPL (which gives rise to insiders' bargaining power) and wage bargaining institutions, specifically the predominance of industry- level bargaining.

### **Croatia's Compressed Wage Structure Reflects the High Incidence of SOEs and Privatized Enterprises in Employment**

6.33 The wage structure is more compressed in Croatia than in most other transition economies. The Gini coefficient – a summary measure of income inequality – amounts to 0.274 in Croatia, while in other transition economies of Central Europe it is around 0.300 or higher (Rutkowski 2001). Earnings dispersion is thus rather modest in Croatia.

<sup>129</sup> Note as well that the average working week in Croatia is 37.5 hours compared to 40 hours in most other countries.

<sup>130</sup> The structure of wage bargaining and its impact on wage pressure is a complex issue which requires further investigation. Here we just point to a potential source of wage pressures observed in Croatia.

However, at closer inspection it turns out that the earnings structure in Croatia exhibits some peculiar features. The wage distribution is compressed at the upper tail-end of the distribution while having a relatively long and heavy lower tail. This is in contrast to other transition economies, where wage distribution has widened mainly at the upper end.

6.34 As in all other transition economies, wage inequalities are much higher in the private than in the public sector. For example, the decile ratio – ratio of top decile to bottom decile earnings – is less than two in the public sector and about three in the private sector. It seems that the primary source of the limited wage dispersion in Croatia is the still the large share of publicly owned and privatized firms in employment and the relatively low share of new private firms— around 40 percent in 2000—in enterprise employment. In the public, sector wages of different categories of workers are determined according to a standard wage grid, i.e., a system of coefficients meant to reflect skill requirements associated with different jobs. The least skilled jobs are assigned the coefficient of one while the most skilled jobs are assigned the coefficient in the five to six range, depending on the firm or industry level collective agreement. Such a system of wage determination, supported by trade unions, is an obvious source of wage compression, as it produces both a wage floor and a ceiling.

6.35 To summarize, the wage structure in Croatia is more compressed than in other transition economies. This reflects the relative lack of dynamism in new private firm employment as well as possibly a more active involvement of trade unions in large enterprises – privatized or SOEs. Unlike other transition economies, the wage structure in Croatia is decompressed at the lower tail of the distribution and compressed at the upper tail. The decompressed lower end, of the wage distribution is likely to reflect the lack of statutory minimum wage and suggests that at the lower end wage flexibility is higher. Since most of those searching for a new job fall in the lower tail-end of the wage distribution – around 45 percent of the unemployed are new entrants to the labor market (compared to around 25 percent in Poland, Hungary and the OECD), wage compression does not appear to be a major explanatory factor of unemployment.

### **Are Skill and Spatial Mismatches a Factor Behind High Unemployment?**

6.36 Unemployment in transition economies is often of frictional and structural nature, reflecting accelerated restructuring and spatial and skill mismatches occurring in its course. These mismatches emerge because new jobs that are being created differ in salient characteristics, such as the skill content and location, from the old jobs that are being eliminated. Accordingly, a faster pace of enterprise restructuring can be expected to lead to more pronounced labor market mismatches and hence higher unemployment.

6.37 Given the slow pace of enterprise restructuring in Croatia and thus limited inflows into unemployment, it is likely that frictional unemployment does *not* play a significant role. In order to gauge the extent of structural unemployment it is possible to compare the skill and location structure of available jobs (vacancies) with the structure of unemployment. While there is no good measure of skill content, a rough proxy like educational attainment may be used. Clearly, this does not allow to differentiate critical attributes such as occupational, computer, communication, language, or managerial skills.

6.38 With this (important) caveat in mind, the educational structure of existing jobs does not differ significantly from the structure of unemployment in Croatia (Table 6.6). This is in contrast to most transition economies, where there is a visible discrepancy between those two structures: the proportion of low skilled jobs is much lower than the proportion of low skilled unemployed. Accordingly, an index of skill mismatch is lower in Croatia than in other transition economies. As noted, this is a far from perfect measure of the extent of the skill mismatch, but nonetheless it suggests that inadequate formal educational attainment of the unemployed is *not* a primary cause of unemployment in Croatia. The biggest gap—a larger share in the unemployed than in the employed—is observed in the vocational school group pointing to the need to restructure this kind of education.

**Table 6.6: The Structure Of Employment and Unemployment by Educational Attainment, 2001 (in %)**

Education	Share in Employment	Share in Unemployment	"Excess supply"
Less than primary	5.6	3.3	-2.3
Primary	17.6	15.8	-1.8
Vocational school a/	22.4	30.2	7.8
Secondary technical b/	32.9	35.5	2.6
Secondary general	3.5	4.9	1.4
College	6.5	4	-2.5
University	11.5	6.3	-5.2

a/ 1 to 3 year courses.

b/ 4 year courses.

Source: Labor Force Survey, CBS; author's calculations.

6.39 As to spatial mismatch, it is difficult to assess its degree due to the lack of relevant data. Other studies documented relatively strong regional variation of unemployment in Croatia, which may point to regional mismatches (Bisogno, 2000). Still, given relatively little variation in the job creation and job destruction rates by region, these regional differences in labor market conditions are more likely to be of a historic nature.

## B. CONCLUSIONS AND RECOMMENDATIONS

6.40 High unemployment is strongly linked to the slow pace of job creation which in turn can be traced back to a poor business environment and, in particular, to strict employment protection legislation. In addition, job creation is slowed down by high unit labor costs which results largely from wage pressure exerted by *insiders* in state-owned or privatized enterprises. Other possible causes of slow job creation and high unemployment, such as the unemployment benefit system, the wage structure, enterprise restructuring and associated skill and spatial mismatches appear to play at best a secondary role. Thus, reforms of the employment protection legislation and the wage bargaining system are key for improving labor market performance in Croatia.

6.41 The overarching objective of such reforms is to enhance labor market flexibility through *deregulation* and *decentralization* of industrial relations in Croatia. The following specific measures should help to achieve this objective – a detailed discussion on legal amendments is provided in the next section.<sup>131</sup>

- Liberalize the employment protection legislation through amending the Labor Code. Specifically;
  - Lower costs of individual dismissals by shortening the notice period and lowering the statutory severance pay.
  - Relax restrictions on the use of fixed-term and temporary contracts.
  - Institutionalize Temporary Work Agencies.
  - Revise the definition of collective dismissals in line with the EU directive in the field, and restrict special regulations so as to apply only to large firms.
  - Decentralize industrial relations, in particular move away from industry level bargaining toward firm level bargaining.

6.42 In addition, to obtain a clearer picture of unemployment and its changes, clear the unemployment register by removing persons who are not actively looking for a job, and thus do not meet the definition of unemployment. This can be achieved by more aggressively applying job availability and search tests, and exchanging information with tax authorities on earned incomes. The Government has recently taken steps to apply job availability and search tests but more needs to be done on exchanging information.

### **C. REFORMING LABOR LEGISLATION FOR EFFICIENT LABOR MARKETS AND CONVERGENCE TO THE *ACQUIS COMMUNAUTAIRE***

6.43 The 1995 Labor Act aimed at modernizing and updating the labor legislation to the standards of the European Community at the time. The structure of the Croatian Labor Act follows the German Labor Act model. The war (1991-1995) and sudden subsequent bankruptcies, however, compromised the final version of the Croatian Labor Act. Reportedly, the main motive for compromise was the political need to preserve social peace during troubling times. Thus, protection of workers' rights was emphasized, as regarding dismissal periods and additional pension rights to avoid social unrest.

6.44 2001 was a year of significant events paving the way for potential long-term reforms in labor matters (a) noteworthy changes were introduced to the 1995 Labor Act. For instance, the working week was reduced from 42 hours to 40 hours (which amounts to 37.7 effective hours per week); (b) the SAA was signed that contains few but important considerations regarding the labor law that will require amendments to the 1995 Labor Act in due time. More importantly, the SAA provides for technical cooperation to Croatia to facilitate the gradual implementation of the *acquis*

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<sup>131</sup> The reforms recommended here are consistent with those agreed upon between the Government of Croatia and the World Bank under the Structural Adjustment Loan (SAL).

*communautaire*; (c) a World Bank Adjustment Loan (SAL) to the Republic of Croatia was approved<sup>132</sup> which supports labor market reform. As part of this program, the Government submitted to Parliament in January 2003 proposed amendments to the 1995 Labor Law which should increase labor market flexibility.

### **Proposed Amendments to the Labor Law – Consistency with EU Directives**

6.45 *“Preconditions for Valid Dismissal”*. The amendments, supported by the SAL, will “ease preconditions for valid dismissal especially in small firms (up to 20 workers)”, such as the “requirement that the employer attempts reassignment or retraining before a worker can be declared redundant”.<sup>133</sup> This is in harmony with the Council Directive 98/59/EC on collective redundancies. According to this Directive, collective redundancy takes place in small firms when over a period of 30 days, 10 or more workers are dismissed in establishments normally employing more than 20 and less than 100 workers. The proposed amendment is consistent with a specific option included in the EU Directive that provides that dismissal of less than 10 workers over a period of 30 days in establishments normally employing no more than 50 workers does not constitute collective redundancy.

6.46 *“Relaxing the Definitions Of Mass Lay-Offs”*. The proposed amendments also relax the definition of a mass-layoff so that it refers to the dismissal of no less than 20 workers within 90 days. This is consistent with Council Directive 98/59/EC on collective redundancies which leaves the option open for countries to determine the number of redundancies for the application of the provisions on collective redundancies. One of the options is to establish the number of redundancies precisely “over a period of 90 days, at least 20 workers”. This means that in case of dismissals of less than 20 workers over a period of 90 days, there is no need for the employer to go through the process of consultation with workers representatives, and putting forward social measures and aid for redeploying or retaining.

6.47 *“Reducing Advance Notice For Termination Of Employment”*. The proposed amendment shortens the advance notice period to a maximum of three months notice for workers with at least 20 years of service. The proposed amendment elaborates on many details in relation to notice for termination.

6.48 *“Reducing Severance Payments”*. The proposed amendment reduces severance pay by applying the revised formula (at the most 1/3 of a month’s salary per year of service) with the ceiling set at six monthly salaries.

6.49 *“Reducing the Duration of Maternity Leave for Readmission to Work”*. The last amendments to the Labor Law in 2001 reduced the duration of maternity leave after which the employer is obliged to readmit the worker to 12 months. Generous maternity

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<sup>132</sup> World Bank, “Report and Recommendations of the President of the IBRD to the Executive Directors on a Proposed Structural Adjustment Loan in the Amount of US\$200 Million to the Republic of Croatia”, Report No. P7490-HR, October 26, 2001.

<sup>133</sup> SAL Agreement, Annex 1, page 47.

leave is typical of socialist labor laws, as motherhood was specially encouraged and protected. Today, however, these provisions in the Labor Law are more detrimental than beneficial to women. They result in discrimination against women in the work place and against women seeking jobs.

6.50 A pervasive problem in Croatia is enforcement of laws and regulations. Incorporating the proposed amendments into the Labor Law should include a specific provision indicating that they will be enforced by virtue of the force of the contracts that contain said clauses. This means that enforcement will be imbedded in the labor contracts based on the amended provisions of the Labor Law. Contracts should include references and literal transcriptions of the relevant new provisions in the Labor Law, as appropriate. Employers will enforce the contracts based in the new provisions in the Labor Law. The new provisions should be disseminated properly to employers, workers and labor inspectors. Labor inspectorates would have to be trained in the meaning of the new labor flexibility provisions to avoid intervention in enterprises caused by unfounded claims put forward by workers based on the old legislation.

### **Labor Issues in the Stabilization and Association Agreement**

6.51 Pending ratification of the SAA, Croatia should undertake as much preparatory work as possible for its implementation. This means establishing permanent working groups on the various subject matters covered by the SAA, including labor issues. In this regard, there is a need to collect data, laws and regulations, update a collection of norms in force, systematize them by subject matters, and analyze them in their actual content and on the needs for amendments, abrogation and new drafting both to accommodate the requirements of the SAA and to transpose the *acquis communautaire*. This will be a painstaking process. It will need to formally start as soon as possible in an environment of technical capability and institutional stability (to ensure continuous and productive results regardless of changes in government).

6.52 The main references to labor matters in the SAA – and in some cases potential costs or benefits to Croatia – are described below.<sup>134</sup>

6.53 **Employment reciprocity.** This issue is related to “Freedom of Movement of Workers”, rooted in the Treaty of Rome and repeated in the SAA. It means that in the EU work permits are not required for workers of member states. Workers of member states may seek employment on the same basis as nationals of the member state where the work is located. They enjoy “national treatment”. The SAA provides that, subject to conditions and modalities applicable in each member state, treatment of Croatian nationals *legally employed in the territory of a member state* shall be free from discrimination, and vice versa. This does *not* mean that Croatian nationals have an unconditional right to seek employment in the EU (Article 45). Croatia should benefit greatly from employment

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<sup>134</sup> They can be found in Title V on Movement of Workers, Establishment, Supply of Services, Capital, Chapter I, Movement of Workers, Articles 45-47; Chapter II, Establishment (self-employment businesses), Articles 48-55; Chapter III, Current Payments and Movement of Capital, articles 59-61; and Title III on Cooperation Policies, Article 91.

reciprocity as it is one of the main mechanisms to train and adjust its labor force while getting better access to organizational and business knowledge.

**6.54 Access to employment facilities.** In due time, Croatia will have to comply with rules and regulations regarding mobility of workers, in particular concerning facilities for access to employment for workers from member states under bilateral agreements. The SAA provides for Croatia to undertake preparatory improvements, such as facilities for access to professional training, in accordance with the rules and procedures in force in the member states, and taking into account the labor market situation in the member states and in the EU (Article 46). Access to employment facilities can constitute an important incentive to regional FDI.

**6.55 Self-employed businesses.** Croatia will have to revise the pertinent legislation to allow the self-employed from member states to take up economic activities in Croatia as self-employed persons, and to set up undertakings, in particular companies, which they will effectively control. This does not extend to seeking or taking employment in the labor market or conferring the self-employed a right of access to the labor market (Article 48).

**6.56 Social cooperation.** The SAA provides for employment cooperation between the EU and Croatia aimed at upgrading job finding and career advisory services, and promoting local development to assist industrial and labor market restructuring. These aspects are critical for job creation. Croatia should take early advantage of this cooperation that includes studies, the secondment of experts and information and training operations (Article 91).

**6.57 Social security.** The SAA also includes cooperation to adjust the social security system of Croatia to EU requirements. Croatia should benefit from this cooperation and from the services of experts, information and training (Article 91). For the EU, the constant promotion of a compatible system of social protection is an important component of the EU-wide employment and social situation. Funding and organizing social protection systems is a responsibility for individual states, but these systems need to be instituted with capacity to develop and operate sustainable and universally applicable social protection systems. Also, these systems must be able to coordinate with the ones in the EU, with their own dynamics and reforms. In particular, the portability of pensions across members is a crucial element – and one of the most difficult to achieve – to enhance labor mobility in the EU, and between the better and associated countries.

**6.58 Working conditions and equal opportunity between women and men.** The SAA includes explicit cooperation with Croatia in legislative revision and drafting to adjust the Croatian legislation on working conditions and on equal opportunities for women and men (Article 91).

**6.59 Health and safety at work.** *For most EU accession countries, complying with the “Health and Safety at Work” component of Chapter 13 of the *acquis communautaire*, has been one of the most arduous tasks. Croatia should take full advantage of cooperation*

under the SAA in these matters (Article 91) and should evaluate on a case-by-case basis the priority given to compliance with EU directives over time.

### **Adopting the *Acquis Communautaire***

6.60 The SAA contains a framework for political dialogue and technical cooperation for the Government to adopt with the *acquis* on “Employment and Social Policy.” This consists not only of labor laws, labor contracts, and hiring and firing, and flexibility; it involves a complex subject matter enshrined in more than a century of labor tradition in Europe. It covers areas with substantial secondary legal *acquis* (directives, resolutions, etc.) on health and safety issues, labor law and equality of treatment between women and men, social dialogue, employment and social protection where policies are being developed on the basis of the EC Treaty are translated into norms and institutions. Complying with new laws and regulations is as difficult as constructing a new institutional environment or re-engineering the existing institutional setting. This may mean abolishing some institutions, merging others, and creating new ones. These processes of institutional development have political and social implications that need to be anticipated.

6.61 **Labor Law.** Updating the broader labor law environment includes the Labor Law, employment laws and regulations, regulations on collective bargaining and on tripartite partnerships, laws and regulations dealing with fundamental human rights and freedoms, protection of special groups of workers, minimum wages and maximum hours of work, annual leave and termination of employment; terms and conditions of employment; settlement of labor disputes and rules for employers’ associations and trade unions. Full compliance may require further revision, classification and updating, including possibly drafting a new legislation.

6.62 The Ministry of Labor and Social Welfare is the competent authority on labor issues. Following the experience in accession countries, the Ministry will need re-engineering to cope with new demands resulting from the *acquis*. Labor legislation is supposedly enforced through the judiciary. Regrettably, the Croatian judiciary is in need of major overhaul. The opportunity should be taken to revise current standings on industrial disputes and perhaps consideration should be given to the establishment of labor courts. The Labor Inspection Service will also need major revision and upgrading in its professional and behavioral standards to avoid corruption and unnecessary inspections and fines that only increase the cost of making business.

6.63 **Social dialogue.** In Croatia, the institutional mechanism for social dialogue is in place, the Social and Economic Council. Tri-partite meetings do take place and issues are discussed in this forum. The reality, however, is that the parties, particularly employers and trade unions, are not solid enough in terms of technical preparation and for constructive discussions. As a result, the positions of the Government tend to prevail. For the EU, social dialogue is not just a formal forum; it is an important instance to be promoted. Croatia needs to accord the required importance to the social dialogue mechanisms and work towards the development of the social partners to cope with their

EU and national duties, and particularly on consultations regarding legislative drafts relating to employment and social policy *acquis*.

6.64 For constructive tripartite dialogue regarding modernization of labor markets, the Government needs to be more transparent and explicit in its legislative proposals and allow time for their study and debate. Employers' associations need to become directly involved and be able to contribute with proposals of substance. Employers' associations are in need of stronger management and professional development as trade associations and self-regulatory organizations. Trade unions that have seen their constituencies diminish need to be strengthened and be better prepared for constructive social dialogue.

6.65 **Equality of treatment for men and women.** The Labor Code needs revision specifically regarding restrictions for women on overtime, night work, and on work during pregnancy that are considered discriminatory. In addition, new legislation and regulations need to accommodate matters such as equal treatment for men and women in employment, parental leave, protection of pregnant workers.

6.66 Operational coordination mechanisms between the Ministry of Justice, the Ministry of Health and other possible entities, such as Women's Rights Councils and related non-governmental organizations to promote equal treatment and equal opportunities in the social and employment fields would be beneficial. The role of the judiciary needs to be evaluated and major reforms introduced for it to play a significant role in enforcement of the legislation. Labor inspectorates also need to be professional and accountable in monitoring and enforcing compliance under clear, transparent and fair procedures.

6.67 **Racism.** Croatia is party to most international legal conventions and instruments on racism and xenophobia. Protection against any form of discrimination is enshrined in the Constitution, and all persons are equal before the law, the administration and justice and are entitled to equal protection and treatment. Because of particular circumstances, there are still problems related to immigration and to the return of Bosnian Croats that need to be resolved both in law and in practice. The relevant EU normative is Council Regulation (1035/97).

6.68 *Administrative and judicial remedies at all levels need to be more readily available for people* claiming to be victims of discrimination. The judiciary is reported not to have been able to fulfill so far its duties properly in this regard. A more proactive role for the Ministry of Justice against discrimination would be needed. Non-Governmental Organizations on Human Rights are very active and their role will have a positive impact and they should be encouraged to expand.

6.69 **Health and safety at work.** The current legal framework is contained in the "Safety and Health Protection at the Workplace Act" of 1996, that is reported to have taken into account the Framework Directive 89/391/EEC. The Act may be in need of revision for satisfaction with the requirements of the Framework Directive and updated in light of latest EU legislative developments. Full alignment with the provisions of the health and safety at work in EU Directives is a major task that needs to be approached

gradually with legislative and regulatory measures that need to take into consideration their impact in production costs and in labor costs. For most countries this component of Chapter 13 has been among the most difficult and costly to comply with. Croatia should seek advice and learn from the experience of other countries in their compliance with “Health and Safety at Work.” The Labor Inspectorate will have to be re-engineered and strengthened to effectively and transparently implement both the existing and the new harmonized legislation.

## Conclusions

6.70 The reforms supported under the SAL, the SAA and the *acquis communautaire* are consistent and conducive to increase the flexibility of Croatia’s labor markets. Parliament is now considering significant amendments of the Labor Law which, once adopted, will enhance labor market’s capacity to adjust to European integration.

6.71 Employers have expressed their support for labor market flexibility policies. However, they do not have strong associations to play a more aggressive and influential role. Trade unions, while they accept the need to modernize and reform the Labor Law, still resist changes which alter the principle of employment as stable and long-term under indefinite employment contracts. This situation leads to continuous stalemates in tripartite negotiations, leaving the initiative for change with the Government. The Government, in turn, tends to decide on short-term politically oriented perceptions. The SAA provides good opportunities for Croatia to adopt the *acquis communautaire* for integration to the EU. On “Social Policy and Employment” Croatia has ample opportunity to learn from the experiences of other countries working towards European integration and should dedicate time and effort to this endeavor and benefit from competent external technical assistance.

6.72 Specific recommendations are:

- The Government needs to set up permanent multidisciplinary research and drafting groups to undertake the work of making proposals to comply with the various issues dealing with European integration.
- Develop a multi-institutional action plan for the gradual implementation of the SAA and eventually the *acquis*.
- Strengthen the social dialogue mechanisms with transparent procedures and with public disclosure of proposals and debates on all proposals related to labor markets and changes in the Labor Act and related labor and employment laws.
- Undertake sustained public information campaigns on labor markets and labor law dynamics.
- Request technical assistance (under SAA, EU Tacis, World Bank) in drafting laws amendments and technical regulations.

## D. EDUCATION STRATEGY

### Assessing Educational Needs

6.73 Croatia's aspirations for European integration have major implications for Croatia's education and training system and its research base. Regardless of prospects for EU accession, Croatia's economy would be more competitive and robust if it were to move increasingly to innovation-driven growth. Characteristically, innovation-driven economic activity consists of rapid change in production processes and products in response to international competition and volatile market opportunities. It depends on the aggressive invention of new ideas and application of existing ones. Typically, stages of economic development include a factor-driven phase – where land, labor and capital are mobilized, an investment-driven phase – in which FDI helps to incorporate technology and integrate the country into the world economy – and an innovation-driven phase – characterized by a high rate of innovation and adaptation and commercialization of new technologies. EU members have features of each of these three phases; however, innovation-driven growth fundamentally characterizes their economies and certainly the future of their economies. Croatia's economy is based primarily on investment-driven growth, although it has problems in its factor markets and some innovation-based activity. The growth strategy proposed in this Report is heavily reliant on the efficient working of good and factor markets. However, as Croatia prepares for European integration, it has to take actions that stimulate the gradual shift to innovation-based growth.

6.74 Innovation-driven growth means that employers have to restructure work; workers need different skills; and education, training, and knowledge production systems have to be restructured to meet employer and employee needs. Employees in an innovation-based economy face different labor markets than those in investment-driven economies. Knowledge-based jobs steadily increase as a share of total jobs. Returns to higher education increase, while relative returns to secondary education weaken, and returns to basic or incomplete secondary education decline sharply. The skill demands of the jobs that workers hold are more apt to change, and workers are more apt to change jobs. Both kinds of change confront workers with the need for continuous retraining.

6.75 To cope with these changes, workers need different skills than those valued in highly stable work environments. They need the foundation skills that position them for continuous learning, especially literacy (comprehension, information-processing, interpretation, and writing), mathematics, and science. They need the capacity to act autonomously and reflectively (critical thinking, problem-solving - the higher order cognitive skills<sup>135</sup>). They need the metacognitive skills - the executive thinking or "knowing how to learn" skills that give them the ability to mobilize and monitor

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<sup>135</sup> Higher order thinking occurs with regard to problems that have certain characteristics. The path of action is not fully specified in advance, nor is the path to a solution mentally visible from any single vantage point. The problem yields multiple rather than unique solutions and requires nuanced judgment and the application of multiple criteria that sometimes conflict with one another. Not all of the knowledge needed to solve it is available (Resnick 1987).

alternative strategies for solving unfamiliar problems. They need to be able to function in teams that are often socially heterogeneous. Since specialized knowledge and skill is more valuable in highly stable environments and rapidly outdated in rapidly changing ones, they need more flexible and less specialized knowledge. Although they need facts to build cognitive frameworks, they need more experience in using skills to solve problems and less time spent on memorization.

6.76 The major purchasers (and therefore financiers) of problem-based knowledge are technocratically-oriented governments, innovation-based firms (including multi-nationals), and in some cases, donors, foundations, and intermediary financial institutions such as economic development banks. *In the absence of a government that seeks and uses knowledge or of a critical mass of innovation-based firms, the arrangements for producing problem-based knowledge do not emerge in any meaningful way.*

### **Is Croatia Positioned to Create the Human Capital and Knowledge that It Needs for Innovation-Driven Growth?**

6.77 Comparisons with OECD countries and other countries within the region, interviews with managers of Croatian firms and policymakers, suppliers, and analysts in the education and training sector, and reviews of the many strategy papers sum up a judgment of significant gaps between what Croatia now has and what it needs to fuel innovation-driven growth.

6.78 The adequacy of Croatia's human capital can be rapidly judged by:

- (a) evaluating Croatia's enrollment rates and expected years of education, relative to those for the OECD;
- (b) comparing the educational profile of Croatia's working age population (25-64 year olds) with the average for the OECD;
- (c) assessing if the graduates of Croatia's education and training system have the types and levels of skills characteristic of EU students and labor forces;
- (d) asking if Croatia's graduates meet the skill demands of Croatian companies that are knowledge-based.

6.79 The status of Croatia in each of these areas is summarized below:

- (a) Croatia has relatively low pre-school enrollment rates, very high basic education enrollment rates, respectable rates at the upper secondary level, and relatively high rates for tertiary education. However, the number of years of education that the average five year old Croat can expect to

complete over his/her lifetime is about four years less than that which the average OECD five year old can expect to complete.<sup>136</sup>

- (b) Table 6.7 compares the educational attainment of the working age population (25-64 years of age) for Croatia and the OECD average. Relative to the OECD, Croatia has a smaller percent that have completed only primary or lower secondary education. It has a much higher percent that have completed some form of secondary education (academic, vocational, basic vocational) - **58 versus 44 percent for the OECD**. Croatia has **only half** the OECD share of tertiary completers.
- (c) Among those that have completed some form of secondary education, Croatia has a much higher percent that have completed only the basic vocational program of 1-3 years that ill-equips graduates for a modern workplace - **32 percent versus only 3 percent for the OECD**. **Against this standard, only 37 percent of Croatia's working age population - versus 64 percent for the OECD - might be expected to have acquired the competencies required by a modern workplace.**
- (d) **Croatia does not know how its students perform relative to Croatian or international standards.** Government and the MoES are to be commended for planning to participate in the 2006 round of OECD's Program for International Student Assessment (PISA) and for applying for OECD membership. In the absence of reliable measures of the performance of Croatian students, the performance of countries comparable to Croatia that have participated in international tests can be used to infer where Croatia may also stand in those tests. PISA and the OECD's International Adult Literacy Survey (IALS) assessments are particularly relevant for assessing how well students are prepared to function in an innovation-based economy. Both PISA and IALS measured respondents' ability to manipulate information to solve problems in the real world, not their academic skills per se or their mastery of a specific school curriculum. PISA assessed literacy in reading, mathematics, and science for a sample of 15 year olds, evaluating their understanding of key concepts, mastery of certain processes, and ability to apply knowledge and skills in different situations. IALS assessed the information-processing skills needed by 16-65 year olds to perform literacy tasks encountered at work, at home, or in the community. It measured individuals' capacities to

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<sup>136</sup> Introduced by UNESCO, this now standard measure uses current enrollment rates for students at each level of education to estimate the number of years that a hypothetical five year old child in the country could expect to complete in his/her lifetime. The data cited here are from the World Bank's public expenditure review in 2000. At that time the hypothetical Croatian child could have expected to complete almost four fewer years of education than the average OECD five year old in 1998 and less than children in selected other countries in the region, such as the Czech Republic (14.4 years), Hungary (13.9 years), or Poland (14.8 years). By 2002 the expected years of education could have increased, but not significantly.

expand and interpret the meaning of verbal and quantitative texts, using three scales: prose, document, and quantitative.<sup>137</sup>

**Table 6.7: Highest Level of Education Completed for 25-64 Year Old Population for Croatia (2001) and OECD (1999)**

Country	Primary/lower Secondary	Basic Vocational	Secondary	Tertiary
Croatia <sup>1</sup>	30	32	26	11
OECD average	36	4	39	22

<sup>1</sup> Croatia's numbers sum to 99 percent because one percent of its 25-64 year olds had completed no education.

Source: 2001 Census, Republic of Croatia Bureau of Statistics; Table A2.1a, p.43, OECD, 2001.

6.80 *Except for the Czech Republic, neighboring countries did not perform well on PISA.* The average scores for ECA countries that participated in PISA were significantly below the OECD average on all three scales: literacy, mathematics, and scientific literacy.

6.81 Scores on IALS were found to correlate strongly with the probabilities of unemployment, wages, and per capita GDP. The amount of variance in literacy scores within a country correlated with the extent of income inequality in that country. Again, except for the Czech Republic, neighboring countries performed poorly on IALS. Three of the four participating ECA countries (Slovenia, Poland, and Hungary) had about 75 percent of 16–65 year old workers who tested at levels 1 and 2 on all three scales.<sup>138</sup> Levels 1 and 2 predict that the individual will have difficulty functioning in a modern workplace. Analyses of IALS data for all participating countries found that achieving the literacy levels required in modern workplaces (Level 3 and above) was associated with having completed upper secondary education. The performance differences between the tested skills of adults in Hungary, Poland, and Slovenia versus those of Czech adults and adults in participating OECD countries could not be attributed to the quantity of education that low performing ECA populations complete. Had Croatia participated in

<sup>137</sup> *Prose literacy* is defined as the knowledge and skills needed to understand and use information from texts including editorials, news stories, poems and fiction. *Document literacy* is defined as the knowledge and skills required to locate and use information contained in various formats, including job applications, payroll forms, transportation schedules, maps, tables, and graphics. *Quantitative literacy* is defined as the knowledge and skills required to apply arithmetic operations, either alone or sequentially, to numbers embedded in printed materials.

<sup>138</sup> *Level 1* indicates individuals with very poor skills. For example, the person may be unable to determine the correct amount of medicine to give a child from information printed on the package. *Level 2* respondents can deal only with material that is simple, clearly laid out, and in which the tasks involved are not too complex. It denotes a weak level of skill, but more hidden than level 1. Individuals may have developed coping skills to manage everyday literacy demands, but their low proficiency makes it difficult for them to face novel demands, such as learning new job skills. *Level 3* is considered a suitable minimum for coping with the demands of everyday life and work in a complex, advanced society. It denotes roughly the skill level required for successful secondary school completion and college entry. It requires the ability to integrate several sources of information and solve more complex problems. *Levels 4 and 5* describe respondents who demonstrate command of higher-order information processing skills.

IALS, its lower secondary completion rates alone relative to the OECD average (26 versus 39 percent of 25-64 year olds) would predict Croatia's lower performance on IALS.

6.82 On the basis of the PISA and IALS results and the comparability between Croatia and Slovenia and between Croatia and Germany, it seems safe to predict that, *had* Croatia participated in these two assessments, their youth and adult populations would have had relatively low mean scores and high inter-school variances.

6.83 How well do Croatia's students perform relative to the skill demands of its knowledge-based firms? As one of the world's 10 largest generic drug companies, PLIVA is a clear example of an innovation-based Croatian firm. It is based on research and development. This firm expressed alarm over the quality of the graduates of Croatian secondary schools and universities. PLIVA has its own skill assessment system that it uses to select among job applicants. It was stated that every year the number of good students shrinks. Fewer than 10 percent of the university graduate applicants meet PLIVA's criteria. In PLIVA's more demanding research and development division, it is fewer than 5 percent.

6.84 The statistics for measuring Croatia's R&D activity and effectiveness are inadequate. However, qualitative and some quantitative evidence indicates that Croatia's R&D system—its universities and research institutes—is limping. **The state micro-manages exactly that sector that most needs to be nimble, flexible, and entrepreneurial.** As of 1996-97, Croatia had about half the number of fulltime researchers per million population as the average for the OECD countries (Flego et al., 2002, Appendix Table A). In 1997-2000, it had about 60 percent of the fulltime researchers per thousand economically active individuals as the EU countries (Flego et al., 2002, Appendix Table B). Research productivity, **as measured by published articles in chemistry only**, is less than EU and most East European countries (Berryman-Drabek 2002).

6.85 Currently, Croatia has 28 public research institutes, one public research center, and several private-sector research institutes, the exact number varying from three to 13, depending on the source. The Scientific Research Activities Law of 1993 constituted a major assault on Croatia's R&D system, fragmenting it and weakening the institutional and functional links between the research institutes and universities. It took away from the universities all research institutes that had been administered by the universities, changed their status to "public institutes", and brought them under the direct administration of the MoST. The adoption of the Law was followed by what Croatians call "purges in science", with ministers of MoST changing many institute directors and replacing them with individuals that were usually not distinguished scientists. The public institutes are now tightly controlled by political appointees, specifically the ministers of the Ministry of Science and Technology. Under the Law on Research and Development the Minister of Science and Technology is responsible for the management and administration of the public (state) R&D institutes.

6.86 **In sum, Croatia's public R&D system has become highly centralized,** with the Minister of MoST directly or indirectly appointing members of the management and scientific councils of the public institutes, appointing and dismissing directors of institutes, and making final decisions on each individual research project. Several of those interviewed said that MoST's bureaucratic micro-management had killed or crippled most of the research institutes. The situation of the institutes has improved over the last two years as MoST has handed over some of decision-making powers to the institutes.

### **Proposed Reform Agenda**

6.87 Policy recommendations fall into three main areas, respectively (a) restructuring the role of the State in education and R&D; (b) improving the State's performance of its functions; and (c) restructuring the curricula, instructional pedagogy, and accountability mechanisms for educational outcomes. There are as well some specific areas where policy initiatives are required; (d) avoid disadvantages of the vocational school system.

### ***Restructure the Role of the State in the Education and R&D Sectors***

6.88 The role and performance of the State is one of the causes of many problems in education and R&D and one of the impediment to fixing them. The State has centralized power in ways that cripple the initiative and accountability of the educational and R&D institutions. It regulates student enrollments, makes decisions on new employment and financing of higher education programs and research activities, and approves new investments. An international consensus about a workable allocation of decision-making powers in the education and R&D sectors among different levels of government and providers implies that the central government should wield a light hand, in contrast to today's heavy hand. It implies a shift (a) from a supply-driven to a demand-driven system of education, training, and research; and (b) from centralized control to decentralized control combined with an accountability for results that should be monitored by the center. *This perspective implies that Government should work with stakeholders to set priorities and standards and use public finance to create incentives for players in the system to meet them*

6.89 At the same time, the central government has critical roles that it should be and is not now playing. For example, the State now controls inputs and processes and turns accountability for learning outcomes over to the schools. This is upside down. *The State should hold schools accountable for learning outcomes and give them the freedom, and, as needed, the technical support, to figure out how to produce them.*

6.90 In particular, Croatia should structure its tertiary education system flexibly to let institutions, faculties, students, and supplier markets adapt to change. Croatia's tertiary system is so rigidly structured that institutions, faculties, students, and suppliers are unable to seize opportunities or adapt to change. Croatia's universities should have single university-wide budgets and the autonomy to take actions in terms of staffing, program, and structure. Government should facilitate private provision where possible, restricting its controls to ones that protect the consumer. These include quality assurance through

mechanisms such as accreditation and impartial information about public and private institutions relevant to consumer choice. The MoST Draft Law on Science and Higher Education proposed some reforms, in mid-2002, that seem to be consistent with these recommendations, but the University of Zagreb challenged these and other proposals envisaged. The biggest risk perhaps was a stalemate due to lack of compromise.

6.91 The new Minister of MoST, appointed in 2002, however, reconciled the two proposals and submitted the final draft Law on Science and Higher Education to the Government. This proposal has received the endorsement of the Croatian Rectors Conference and, most importantly, has been submitted to the Parliament. It contains proposals that are intended to eliminate barriers to the development of innovation-driven growth, such as university and research institute fragmentation, co-management of higher education and R&D by the State, centralized financing, underdeveloped quality control of higher education institutions and programs, and unequal regional development of higher education and R&D. It also proposes establishing two independent agencies (one for higher education and one for R&D) that will be responsible for evaluating programs and institutions. Decisions on financing individual institutions and programs will be made on the basis of these evaluations. Finally, it provides the basis for integrating into the European Area of Higher Education and Research by introducing the European Credit Transfer System.<sup>139</sup> It is important to stress that the EU is supporting these reform efforts through 16 projects within the TEMPUS program and 3 CARDS projects.

6.92 The analysis implies two roles for Government in R&D. One is dealing with market failure. Individual companies do not have incentives to invest in basic research because of the “free rider” problem, i.e., one pays and many benefit. Since basic research enters the general domain of knowledge, a company cannot monopolize the returns on its investment. Thus, *the State should focus its direct R&D investments on basic research.*

6.93 The other R&D role for the State is creating a positive institutional environment for companies to invest in R&D. As a percent of GDP, Croatia’s public investment in R&D is below the average of that for the European Union, but not significantly so. Low investment by the private sector seems to account for the fact that Croatia’s public and private investment is about half that of the European Union. *MoST should contract for a competent evaluation of corporate impediments to investing in R&D.* The evaluation should identify Government actions that can create a positive institutional environment, e.g., easing the patent application process, enforcing patents, protecting intellectual property rights, or using tax policy to create fiscal incentives for firms to invest in R&D.

6.94 The State should clear away legal and regulatory impediments to R&D and use public financing to create incentives for high quality, entrepreneurial R&D. For example, increasing the production of young scientists is instrumental to meeting the R&D objectives. The research institutes could become a training base for university graduate students. Fully functional research institutes have the equipment, laboratories, the cross-disciplinary teams, and the project focus that PLIVA identified as missing in the training

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<sup>139</sup> The European Credit Transfer System is already being piloted in some institutions of higher education.

of young scientists. Using competitive grants, the State might fund the costs of properly equipping the winning institutes and some staff time in exchange for training graduate students.

6.95 The State might want to reward the institutes for relying heavily on university faculty to conduct their R&D work instead of building up expensive permanent R&D staffs. This arrangement reduces costs, supplements faculty salaries, gives faculty access to equipment, laboratories, colleagues in other disciplines, and projects, and creates a dense functional collaboration between the institutes and the universities. The State might reward institutes that meet certain targets over time in terms of the quality and marketability of its intellectual and technological products. It could reward institutes that merge or weed out unproductive staff or that create productive partnerships with private companies.

6.96 The Government strategy aims to address some of these issues. The MoST 2002 strategy for science development anticipates a facilitative role for the State. For example, it discusses concepts of science and technology parks; incubators that have access to scientific, financial, legal and managerial services; an Agency for Commercial Utilization of Scientific Research that connects firms and research entities; providing incentives for institutes to create centers of excellence; reducing the brain drain of good young scientists by improving their career options; establishing collaborative links with Croatian scientists abroad; and encouraging small and medium-sized enterprises to use R&D by exploring collaborations between MoST and the Ministry for Small and Medium Enterprises.

***Improve the State's Performance of Functions Appropriate to It***

6.97 The Government in Croatia has great difficulty in managing horizontal (i.e., cross-sectoral) reform. It has problems of policy consultation and coordination, strategic capacity, analytic capacity, and policy continuity. These management weaknesses are echoed in Government's management of the education sector. In fact, the MoES and MoST seem to have the will, but lack the capacity, to produce change. The Government is better today than it was five years ago at diagnosing problems in the sector. However, it is stronger at seeing pieces than at identifying causal links. *It lacks policy-relevant statistics, analyses, and evaluations.* Accordingly, diagnoses are impressionistically, not empirically, based. It cannot really set up and run an effective change process that demands technical, political, and operational skills. Today's leadership can identify what is wrong, but does not know how to fix it. The endless reports have a number of good ideas. However, they reflect an ability to describe and an inability to transform the system. These reports thus remain "theoretical" in that resources are not mobilized to implement the changes proposed in them. The MoES was successful in having the Government adopt its reform proposal. The proposal was then submitted to Parliament for approval. The Parliament rejected the proposal, returning it to the MoES.

6.98 In the absence of a broader public sector reform, the education ministries (MoES and MoST) can still take some steps. Both ministries should start with a performance audit that evaluates how well each is organized to conduct the generic tasks for which

they should be responsible. The audit review should produce recommendations on how to restructure each ministry to perform these functions, e.g., amalgamating scattered functions; identifying staffing and capital requirements, such as particular software packages for financial estimates, performance audit systems, job descriptions, and hiring criteria; and the technical assistance that will be required to train staff to perform their new responsibilities effectively.

***Significantly Restructure the Curricula at All Levels Of Education, Instructional Pedagogy, and Accountability Mechanisms for Educational Outcomes***

6.99 Modernizing Croatia’s education system requires changing what is taught (curriculum), how it is taught (pedagogy), and the accountability of those at the point of service delivery for results.

6.100 **Curriculum.** For all levels of education the curriculum emerged as the major culprit and barrier to developing the human capital that Croatia needs to support innovation-driven growth. The curriculum has age-inappropriate material that does not fit the cognitive capacities of the students, or grade-inappropriate material, where topics introduced in a grade presume knowledge that is not introduced until later grades. It requires the learning of large numbers of detailed facts that are divorced from meaningful context. There is a broad consensus that the curriculum needs to support more project-oriented learning, and to develop the higher order and executive thinking skills. Revising the curriculum will have to include setting new learning standards by grade and subject as a basis for (a) setting targets for teachers and students; (b) evaluating the learning performance of the schools, i.e., a basis for accountability; and (c) comparable assessments of student learning.

6.101 A significant revision of a curriculum in and of itself is not particularly costly. However, major curricular changes are worthless if they are not accompanied by corresponding changes in (a) all textbooks, teacher guides, and learning materials; (b) teachers’ classroom practices; and (c) measures of learning outcomes. New textbooks and changes in teachers’ classroom practices will have a significant budget impact.

6.102 **Pedagogy.** Although the curriculum (what is taught) and pedagogy (how it is taught) are not the same, they are deeply intertwined. The “right answer” focus of the current curriculum significantly restricts pedagogic options. *The education sector needs a very different pedagogy, one that develops students’ responsibility for their learning, rewards their initiative, and develops the higher order and executive thinking skills.* If the attempt to modernize the system fails at the level of the classroom and the school, it fails overall. Its success depends on what teachers do and think—it is as simple and as complex as that.

6.103 **Build the implementation of the system’s modernization around teachers and school administrators.** Although bureaucrats, parents, and students are also important parties to implementation, the burden of a quality reform is on those whose daily professional behaviors have to be recast if the experience of learning is to be changed. To be successful, reform has to respect the world confronted by those asked to change. The

point of the implementation process is to exchange the policymakers' reality of what should happen with that which is faced by implementers. Typically, however, teachers are often viewed as conduits for instructional policy, not as actors. This view encourages policymakers to invest in controlling teachers rather than working with them to help them develop understanding and changed practice. Studies show that successfully implementing reform at the level of the school and classroom depends on sharing power and allowing discretion and initiative at the school level, instituting well-designed and continuous staff development, and holding school-level staff accountable for results.

6.104 **Accountability.** Build accountability for results around interpretable international and national assessments of learning. The first step is to benchmark the learning outcomes of Croatian students against those of their EU counterparts by participating in PISA. As noted above, the MoES has made progress in this direction by receiving an endorsement from the Government to request Croatia's participation in the next round of PISA (2006).

6.105 The second step is to conduct regular **national** assessments of learning at different levels of education. Learning assessments for the different cycles of pre-tertiary education are mostly school-based, i.e., written and administered by the school. Since school-based assessments are not comparable to each other and therefore not interpretable nationally, Croatia needs to engage in **nationally** written, administered, and scored learning assessments. The MoES has made progress in this direction by piloting such nationally and independently written, administered and scored learning assessments (the so-called "state matura") of secondary graduates in several Zagreb gymnasiums this year. This pilot will be succeeded by a nation-wide external assessment of general academic graduates conducted by an independent assessment institution in 2004.

***Ensure That Secondary VET Students Are Not Disadvantaged by This Track***

6.106 In 2001, 72 percent of Croatian secondary students were enrolled in some form of vocational/technical education. Thirty percent were enrolled in the shorter and less demanding vocational program. EU economies are much less forgiving of low skills than mass production economies. Croatia's education system tends toward earlier and narrow specialization that can stunt the development of the foundation skills for those in "applied" or vocational tracks. This policy deserves to be revisited. It is inconsistent with the education found to be preferable for a modern economy: broad-based preparation with specialization reserved for higher levels of education. The MoES 2002 strategy anticipates several types of secondary VET education. The proposed reform has desirable elements designed to increase the horizontal and vertical mobility for students. At the same time, Germany has similar opportunities for mobility, but very few are able to use these successfully. More worrying, the various VET options—especially programs of three or fewer years—open up chances for significant variation in students' mastery of the foundation skills. This does not mean that all students have to go through academic curricula at the upper secondary level. Vocational/technical programs can have substantial academic content. For the academically less inclined, instructional programs

that *integrate* academic and vocational content are highly effective at achieving a quality education.<sup>140</sup>

6.107 It is reassuring that Croatia is working with the EU through the CARDS 2001 VET project to develop the foundations of a modern, flexible, demand-driven, and high-quality vocational education and training system.<sup>141</sup> As Government reforms its VET system, it is recommended that it consider these proposals:

- restrict occupationally-specific training to the tertiary level,
- limit its secondary VET programs to ones whose completion give students access to faculties in their secondary fields of study *and to the matura*, and
- use the academic/vocational integration model to shape these programs.

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<sup>140</sup> For example, LaGuardia High School in New York City is organized around the repair of aircraft engines. In the context of learning something that real people do in the real world, students acquire the academic foundation skills and knowledge that position them for adult learning and adaptation. The students have to use mathematics, decode the complex manuals published by the manufacturers of different kinds of engines, and exercise diagnostic and problem-solving skills.

<sup>141</sup> The CARDS 2002 (VET: Modernization and Institution Building) and CARDS 2003 (Upgrading of VET Schools - Establishing Centers of Excellence) projects are expected to build on CARDS 2001.

## **7. MODERNIZING INFRASTRUCTURE – AN OPPORTUNITY FOR PRIVATE SECTOR DEVELOPMENT AND REGIONAL INTEGRATION**

7.1 Croatia's infrastructure development is an integral part of the growth and integration strategy. In line with EU directives, the private sector is called to play a critical role in the modernization of the sector. It constitutes not just an excellent business opportunity for private investors – and to that extent will impact favorably on aggregate demand; it will more importantly contribute to strengthen the supply side of the economy. The modernization of infrastructure services is needed to enhance the global competitiveness of Croatian goods and services within European markets. In this context, the Government is called to play a major role in terms of the development of the regulatory framework for efficient deregulation and privatization of infrastructure, for ensuring the provision of public goods and for compliance with EU investment and environmental requirements and directives. This chapter focuses on two of the infrastructure sectors with the greatest potential for private sector participation and for spill-over productivity effects to the rest of the economy – the energy sector and the transport sector.

7.2 The efficient provision of energy services is important for promoting private-sector growth and for enhancing Croatia's ability to compete with the rest of Europe. Academic evidence and the experience of many countries suggest that the use of market mechanisms will, in many cases, be the most conducive for the development of an efficient energy sector. The SAA has provisions for the energy sector, aimed at modernizing Croatia's infrastructure and harmonizing the energy regulatory framework with that of the EU. Article 101 of the SAA states that 'cooperation will reflect the principles of the market economy and the European Energy Charter Treaty,<sup>142</sup> and will develop with a view to the gradual integration of Europe's energy markets.' Additional requirements emanate from the infrastructure strategy for South-East Europe, designed by the European Commission in 2001.<sup>143</sup>

7.3 Similarly, the development of an efficient transport sector is a vital prerequisite for a flourishing market economy. And the experience of many countries also suggests that the use of market mechanisms will, in many cases, be the most conducive for the development of such a transport system. This is the principle that guides much of *acquis* in relation to transport policy. Since the end of hostilities, Croatia has moved a long way towards developing a transport sector along these lines, for instance, through the

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<sup>142</sup> Energy Charter Treaty (1994).

<sup>143</sup> European Commission (2001a).

liberalization of the road haulage sector, or the (ongoing) restructuring of Hrvatske Zeljeznice (HZ, or Croatian Railways) so that the transport sector meets the needs of a functioning market economy. However, there remains much to be done to achieve the mutually reinforcing targets of meeting EU accession requirements and establishing a transport sector based on market principles.

7.4 The rest of the chapter will consider the progress that has been made so far and future reforms that will be necessary for compliance with the requirements in the SAA in the energy sector (Section A) and the transport sector (Section B). In so doing, it will, where possible, examine the likely costs and benefits of making the necessary reforms, and propose recommendations that aim to minimize the costs and maximize the benefits of these reforms.

### A. THE ENERGY SECTOR

7.5 Croatia has already moved a long way towards developing its energy sector along lines consistent with the *acquis*. So far, the reforms have focused on the introduction of new energy laws which are creating a framework for: restructuring; privatization; institutional reform; and liberalization.

7.6 The restructuring of energy companies to comply with EU directives is under way, alongside privatization plans.<sup>144</sup> However, much remains to be done in this respect, as well as to establish an energy sector based on market principles. Once principles are in place, there remains the sizeable agenda of implementing these provisions, regulating energy networks, and eventually introducing competition.

#### Current Situation in the Energy Sector

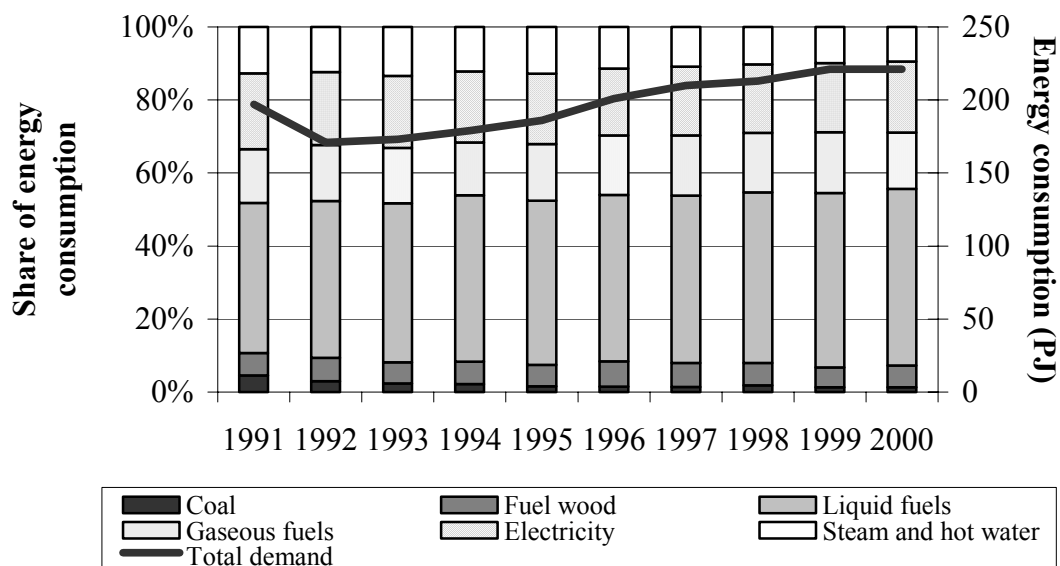
7.7 Energy consumption per capita is low - 2,809 kWh/capita in 1999, compared to an average of 7,841 kWh/capita in OECD countries.<sup>145</sup> Croatia's energy demand has risen at an average rate of 3 percent per annum since 1992, after having dropped at the beginning of the decade. The structure of the total primary energy demand in Croatia has remained stable since the beginning the decade. As shown in Figure 7.1, liquid fuels are the principal energy source in Croatia, consistently representing more than 40 percent of total consumption over the last decade. Electricity is the second most consumed energy, satisfying roughly 20 percent of total consumption, while gas represents around 15 percent of total consumption.

7.8 Liquid fuels cover nearly half of Croatia's primary energy supply, followed by natural gas (25 percent) and hydro (17 percent). Until 1999, nuclear energy covered about 10 percent of Croatia's primary energy supply. Overall, more than half of Croatia's primary energy supply is produced from domestic resources. Crude oil is the primary source of energy imported, before natural gas and, to a lesser extent, electricity and coal.

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<sup>144</sup> European Parliament and the Council (1996) and (1998).

<sup>145</sup> International Energy Agency (2001), pp. 49–51.

**Figure 7.1: Final Energy Consumption by Fuel (PJ)**

Source: Ministry of Economy, Energy in Croatia.

7.9 The growth of the share of imports in Croatia's primary energy supply, particularly oil and gas, over the last decade is due to: pricing that is not cost-reflective, declining reserves within the country; and reserves (wholly or partially) owned by the country's largest oil and gas group, Industrija Nafta d.d (INA) outside the country.

7.10 The energy sector, comprising coke, refined petroleum and nuclear fuel, provides a greater contribution to Croatian exports than to imports. In 2000, energy exports, in particular, oil and oil derivatives, contributed 10.2 percent of total exports and less than 1 percent of imports. Net energy exports was over US\$400 million.

7.11 Energy policy and the planning of the development of the energy sectors are the responsibility of the Government, in particular the Ministry of Economy. Under the Energy Law, the Government is required to propose an Energy Strategy for a period of 10 years to the Croatian Parliament, which then discusses and adopts it.

7.12 Major energy reform legislation was passed by the Croatian Parliament in July 2001. This consisted of five new laws which came into effect on January 1, 2002, which sought to harmonize the Croatian legal framework with the relevant EU directives. The legislation provides for the liberalization of the Croatian energy markets and the restructuring of the main state-owned energy companies - Hrvatska Elektroprivreda d.d. (HEP), INA and Jadranski Naftovod d.d. (JANAF) - with the intention of developing competitive energy markets and attracting private investment in the energy sector. Complementary legislation was passed in early 2002, and more is being considered regarding the planned partial privatizations of the three companies. The five energy reform laws are summarized below.

- The Energy Law establishes rules for accountability and transparency through:
  - defining the principles of energy policy;
  - regulating conditions for energy activities (licensees);
  - setting out the rules of business operation and regulation;
  - promoting energy efficiency, the use of renewable sources and environmental protection;
  - regulating energy prices, tariff systems and general supply conditions.
  
- The Law on the Electricity Market establishes the conditions for the competitive electricity market, including:
  - regulated third-party access (TPA);
  - an independent system and market operator;
  - a public-service obligation;
  - supply as a commercial activity (with the eligible customer threshold set initially at or above 40 GWh and coming into force with the Act).
  
- The Law on the Gas Market establishes the conditions for a competitive gas market, including:
  - access to imported gas by buyers who will consume large quantities of gas themselves or use it for cogeneration;
  - a public-service obligation;
  - gradual opening of the market, beginning with gas-fired power generators, co-generators and final customers whose annual consumption exceeds 100m m<sup>3</sup>.
  
- The Law on the Regulation of Energy Activities includes two main objectives:
  - establishing the Croatian Energy Regulatory Council (CERC) as an independent regulatory authority and setting out its functions; and
  - providing the framework for restructuring of the main energy companies
  
- The Law on Oil and Oil Derivatives Market establishes the framework for access to oil and gas pipelines, through:
  - introducing a price cap;
  - introducing transport tariffs;
  - establishing negotiated TPA to transport systems.

7.13 The energy laws do not set a precise time frame for liberalization, apart from unbundling requirements by the end of June 2002. All five laws adopted in July 2001 include penalty provisions (cash fines and imprisonment) to be applied in the event of an offence by an energy undertaking.

7.14 Day-to-day regulation and the development of effective competitive market structures will be the responsibility of CERC and it should make decisions by majority votes of all its members. It will have the following main responsibilities: granting and suspending of licenses for carrying out energy activities, ensuring transparent and non-discriminatory functioning of the energy market, ensuring transparent and non-discriminatory performance of energy activities subject to public-service obligation, authorizing new generation capacity, and settling disputes.

7.15 **Electricity supply.** Over the last decade, Croatia's electricity supply industry has been dominated by a vertically integrated state-owned company, Hrvatska Elektroprivreda d.d. (HEP). HEP was founded in July 1990 as a state-owned public enterprise. Since December 1994, it has operated as a joint-stock company, 100 percent of which is owned by the State. HEP currently carries out the activities of generation, transmission and distribution of electricity; it also operates the national power system. The company has a virtual monopoly, supplying about 95 percent of the total electricity requirements in Croatia. The remaining 5 percent is produced in industrial cogeneration plants, mainly for the consumers' own needs, and in small, private hydro power plants. The Law on privatization of HEP, which was adopted in March 2002, established the framework for partial privatization of HEP.

7.16 The Law on the Electricity Market intends to produce market structures conducive to competition. This includes the introduction of regulated third party access (TPA) to the network, and the creation of an independent system and market operator (ISMO). A *market operator* established in 2002 is responsible for the organization of the electricity market, including: recording all contract obligations; collecting and selecting the most successful tenders for meeting the demand for electricity; etc. The *system operator* is responsible for operating and controlling the electricity system; ensuring access to third parties on the basis of regulated tariffs; balancing supply and demand for electricity with respect to contracted quantities on the organized market; etc.

7.17 Tariff revision is currently being discussed between HEP and the Government in order to enable further progress. The Government's commitment to energy-sector liberalization was shown by an increase in electricity prices in October 2000 to more realistic rates, shifting some of the cost burden from industry and the state budget to the public. However, it is believed that prices remain too low compared to costs. There are currently no separate charges for generation, transmission, distribution and supply of electricity. However, the coming changes in the electricity market will make these charges more transparent. The Law on the Electricity Market establishes regulated TPA on a non-discriminatory basis. A tariff for electricity transmission will be set on the basis of the network development and construction plans that the system operator and the distribution operator have to prepare for the development and construction of the networks for three-year periods and which are subject to the approval of CERC.

7.18 **The oil and gas industry.** Over the last 30 years, Croatia's oil and gas industry has been dominated by the vertically integrated state-owned INA, which has played a

significant role in the development of the industry throughout the region. Current developments in the sector have been initiated by the Law on the Gas Market<sup>146</sup> and the Law on Oil and Oil Derivatives Market,<sup>147</sup> which were both adopted in July 2001. The new legislation establishes the conditions for a competitive gas market, including gradual opening of the market and negotiated TPA to the gas-transportation network. However, no timetable is set for alignment with the EU *acquis*. With respect to the oil sector, reform has consisted of establishing the framework for negotiated TPA access to oil and gas pipelines, and introducing tariffs methodology.

7.19 INA is the dominant player in Croatia's oil and gas markets. The principal activities of INA and its subsidiaries include: exploration and production of oil and gas deposits, primarily onshore and offshore, within Croatia and abroad; importing natural gas and ensuring the transmission of imported and domestically produced natural gas to industrial consumers and municipal gas distributors; refining and processing of oil-derived products in its fuels refineries and lubricants plants; distributing fuels and associated products through a chain of some 401 retail outlets currently in operation throughout Croatia; trading crude oil and petroleum products. INA's exploration and production activities take place in Croatia and abroad. Croatia has limited indigenous energy resources, mainly located along the Hungarian border and the Adriatic sea. Around two-thirds of the country's crude oil consumption comes from overseas fields operated by INA.

7.20 The INA Group has undergone some restructuring since the Government announced its initial privatization plans in 2000. For example, the parent company INA holds the exploration and production, refining and retail businesses and owns the stake in JANAF – the Adriatic sea oil and gas pipeline. Enterprise restructuring included the reorganization of INA's natural gas business, in particular, the creation of a separate natural gas transmission operator, Plinacro, in January 2001, which has been transferred to INA's gas transmission pipelines, measurement station and dispatching center. The Law on the Gas Market establishes that Plinacro has to enable access to the transmission system to gas suppliers and/or eligible consumers, in an objective and transparent manner. The law also specifies that TPA shall be based on the tariffs for transportation of oil and oil derivatives methods or combination of such methods.

7.21 The privatization of a minority stake in INA is now underway. Binding offers for 25 percent plus one share of INA were received from three international bidders in January 2003. The Government will decide on the bids by end-June 2003. The Government has decided that JANAF will not be privatized in the near future.

7.22 Croatia has deregulated fuel oil prices, and partially deregulated gasoline, diesel, gas oil and heating oil prices. From January 18th 2001, a new pricing mechanism was introduced to determine prices of gasoline, diesel and light fuel, at both wholesale and retail levels. As a result, the price of oil product changes automatically every two weeks,

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<sup>146</sup> Republic of Croatia (2001c).

<sup>147</sup> Republic of Croatia (2001d).

following the change of spot prices of oil products, import prices and exchange-rate movements. With respect to natural gas, the present tariff system is calculated on an average cost basis and is subject to cross-subsidies between domestic and industrial consumers. It is generally considered that gas prices are too low and subject to cross-subsidies. Rebalancing and an increase of tariffs is expected in order move towards cost-reflective tariffs and enable investment, notably expansion of the gas network.

### **Issues and Recommendations**

7.23 In order to meet the objectives of the Croatian Government, substantial investment programs will be required to modernize the electricity, natural gas and oil networks, increase their coverage, maximize the utilization of resources, diversify sources of supply and enhance security of supply. To ensure the creation of an efficient energy sector, the Croatian Government will need to develop energy policies that encourage substantial investment in infrastructure to underpin any drive towards market liberalization.

7.24 In order to provide the right signals for an efficient level of investment in the Croatian energy system, and to attract foreign investors, it is crucial to set up an appropriate incentive framework. Important features of such a framework include:

- transparency and certainty of the reform process, minimizing the risks perceived by potential investors;
- credibility of the regulatory system, through clear division of responsibilities between the Government, Parliament and the regulator;
- efficient, cost-reflective tariffs which provide adequate signals to investors.

7.25 These issues are discussed below, after clarifying the scope of nature of the SAA requirements with respect to Croatia's energy sector.

### ***Complying with SAA Requirements***

7.26 The SAA has provisions for the energy sector aimed at modernizing Croatia's infrastructure and harmonizing the energy regulatory framework with that of the EU. Article 101 of the SAA states that:

*cooperation will reflect the principles of the market economy and the European Energy Charter Treaty,<sup>148</sup> and will develop with a view to the gradual integration of Europe's energy markets.<sup>149</sup>*

7.27 The SAA then specifies that coordination should include, in particular:

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<sup>148</sup> European Energy Charter Conference (1994).

<sup>149</sup> Stabilization and Association Agreement (2001), Article 101.

- the formulation and planning of energy policy, including modernization of infrastructure, improvement and diversification of supply and improvement of access to the energy market;
- the management and training for the energy sector and transfer of technology and know-how;
- the promotion of energy saving, energy efficiency, renewable energy and studying of the environmental impact of energy production and consumption;
- the formulation of framework conditions for restructuring of energy companies and cooperation between undertakings in this sector; and
- the development of a regulatory framework in the field of energy in line with the EU *acquis*.

7.28 Additional requirements emanate from the infrastructure strategy for South-East Europe designed by the European Commission in 2001. The Commission has developed a regional strategy aimed at creating ‘modern and efficient energy infrastructure networks (for electricity, oil and gas)’ and ensuring ‘an adequate supply of energy’, ‘the region’s security of supply, and the necessary interconnection between the region and the neighboring systems.’ Implementation of the strategy, or at least the commencement of the projects involved to fulfill it, is expected by 2010.<sup>150</sup>

7.29 The Commission set differentiated objectives for the power, oil and gas networks. In the electricity sector, the Commission’s strategy includes the rehabilitation and development of the infrastructure networks and their interconnections both with the European electrical interconnected networks of the Union for the Coordination of Transmission of Electricity (UCTE) and among themselves, according to UCTE criteria. The Commission’s strategy also incorporates the development of a regional electricity market, which the countries of the region have committed themselves to establish by the end of 2006. The Commission suggests that ‘if appropriate measures are taken, no new power production capacity will be required in the short and medium term.’

7.30 In the oil and gas sectors, the focus is on improving security and diversity of supply, as well as enhancing transit capacities to neighboring markets. It is recommended that future large-scale projects—in particular, the development of new transportation routes—be assessed by analyzing ‘the advantages, problems, obstacles, costs and benefits of the various options’. The following principles were set by the Commission to guide decisions on new transportation routes:

- Decisions regarding the development of particular routes should be taken according to purely commercial criteria by the commercial operators.
- In the medium to long term, a policy of multiple routes should be promoted. This entails that, in the medium to long term, competition between the route options should be encouraged.

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<sup>150</sup> Croatia is now investing in the reconstruction of a power station in Ernestinovo (400 kilovolts) which is a component of the regional connection of electric system in Southeast Europe.

7.31 In order to implement the European Commission's strategy, reforms need to be undertaken at both national and regional level, including cost-reflective tariff systems, unbundling, liberalization and regulation. The Commission also stresses environmental concerns, recommending that 'projects selected for finance should, when appropriate and possible, be subject to an Environmental Impact Assessment in line with the relevant EC directives.'

7.32 Financing of investment in the energy sector, particularly for oil and gas, is expected to rely on private funds. However, loans from the international community might be granted for projects which, although viable and profitable, do not attract private investment (e.g., cross-border transmission projects, for which the principal beneficiaries are not in the countries where the projects are located). Progress in promoting reforms may become a condition for funding future investment in the region.

7.33 The preliminary energy sector development strategy released by the Government, Strategy 21, appears in line with the above. It states:

*For various reasons it is not expected that investment funds will be supported from the state budget in case of the network energy systems. In case of well-designed projects, private capital will be attracted, and participation of international institutions is also expected. It is recommended that the relation between the domestic and the international financing sources in the energy sector should be 85:15 in favor of the first. Considering the investment needs in the energy sector, savings and capital should be mobilized through domestic capital markets. Measures are necessary to attract domestic savings with the purpose of financing network systems.*

7.34 Investment plans for the next decade are approximately US\$5 billion of which electricity would represent US\$1.15 billion and oil and gas, US\$3.85 billion – almost two-thirds exploration and development. With significant investment required, it is important that the Croatian government is able to prioritize its investment program according to relevant criteria - meeting European integration requirements, enhancement of the South-East Europe regional network.

7.35 The development of electricity generation and the transmission system should take into account the interconnected nature of the region's electricity grids. A regional approach is likely to provide significant benefits in the form of future investment savings, opportunities for electricity trade, higher security of supply and reduced environmental impact. However, as Croatia is heavily reliant on inefficiently priced electricity imports, investment decisions should allow for the elimination of current price distortions so that there is no over-investment and interconnection prices should become competitive with existing generation.

### ***Ensuring the Success of Energy Reform***

7.36 The passage of the energy law package was an important step toward meeting the requirements of the SAA and other requirements emanating from the regional strategy designed by the European Commission. The Croatian Government has already redefined part of the legal framework to increase the efficiency of the system, and provide an attractive environment to enable foreign investment and partial privatization.<sup>151</sup> However, the current framework for the energy sector remains uncertain due to lengthy discussion of the secondary legislation needed to implement the July 2001 energy law package. This section discusses key factors in developing a successful framework for energy reform.

### **Importance of Network Investment**

7.37 Croatia needs to have energy networks capable of supporting competition, or else constraints on entry in the electricity and gas markets will arise. International experience has demonstrated that the cornerstone of efficiently operating energy markets is a sufficient, robust infrastructure. As a recent article from David Newbery argued, ‘unless markets are made more contestable, transmission capacity expanded and adequate generation capacity ensured,’ liberalization may not deliver the expected results.<sup>152</sup>

7.38 Significant investment requirements have been identified by the Government and the main energy companies to: reconstruct parts of the networks that have been damaged during the war; upgrade facilities to conform with EU standards; and extend energy networks, nationally and at interconnection points with neighboring countries and the Trans-European Networks system.

7.39 Given Croatia’s investment needs, it is crucial that the energy reform creates incentives for private investment in Croatia’s energy networks (i.e., to create an environment where investors are confident to recover the costs associated with their investment over the life of the asset). This will require the establishment of *a credible pricing and regulatory regime with limited regulatory risk*, i.e., the establishment of a regulatory contract on how costs will be recovered over time. Without such a contract, potential investors would insist on long-term contractual guarantees for their revenues, as well as high rates of return to compensate regulatory risk.

7.40 Determining the nature and timing of reform, specifying when changes will be decided and implemented and how this will impact on prices and regulatory requirements will require consideration of wider social and economic issues. The impact of these changes on consumer groups and other market participants should be considered in order to determine the time period over which to unwind distributional aspects of energy prices.

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<sup>151</sup> Directions for energy policy and measures designed to implement liberalization and network regulation are currently under discussion and cannot be assessed at this stage. The latter include the Grid Code, legislation relating to tariffs, and the statute of CERC.

<sup>152</sup> Newbery (2002).

7.41 The Croatian Government will need to have an understanding of the potential *implications of liberalization and develop a robust strategy, which clearly indicates the charging regimes and thus the likely cost recovery for network investors. Clarifying the speed of liberalization and price change over time would enable potential investors to identify at the outset the likely speed and impact of liberalization on their returns.*

### **Development of the Regulatory Regime**

7.42 A majority of EU members have an independent energy regulator with well-specified duties. In Croatia, CERC has been established as an independent regulator for the electricity and gas markets. However, CERC has so far played a small role in tariff-setting. This situation is likely to last until 2005/06, which may impair the credibility of the regime. As the electricity transmission and distribution fees will be set on the basis of network development and construction plans for a three-year period,<sup>153</sup> it is expected that CERC will not play a significant role in tariff-setting before 2005/06, when tariffs will be revised. The current situation is likely to limit the credibility and effectiveness of the regulator and increase investors' perception of regulatory risk.

7.43 CERC should be vested with the necessary powers and resources to conduct a price-control review and determine the principles against which it will assess end-user and network pricing going forward. The length of the price control should also be established in view of the regulatory contract established by the Government. Price controls are not usually shorter than five years and could be longer where strong investment incentives are needed.

7.44 In order to establish clear price-control principles, CERC should be provided with sufficient resources as soon as possible, both financially and in terms of expert advice (beyond the working relationship with the Energy Institute). As CERC members have sound technical expertise, but little expertise in terms of liberalization and regulation, the regulator should be allowed to look for assistance outside Croatia on issues relating to competitive energy markets and network regulation. Over time, this would allow CERC to build up their expertise on energy regulation.

### ***Energy Policy and Environmental Commitments***

7.45 Croatia's energy strategy needs to include environmental commitments. Croatia became a party to the UN Framework Convention on Climate Change (UNFCCC) in 1996, thus committing to maintain greenhouse gases (GHG) emissions at their 1990 levels.<sup>154</sup> Croatia has also signed the Kyoto Protocol, which requires it to reduce its emissions of GHGs by 5 percent in relation to the base year over the period 2008

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<sup>153</sup> See Republic of Croatia (2001*b*), Article 12. In natural gas, development plans will be prepared for five-year periods, but there is no mention of the length of the price controls (see Republic of Croatia (2001*c*), Article 7).

<sup>154</sup> However, the Convention allows a certain degree of flexibility for countries with economies in transition, including the choice of the reference year for GHG emissions levels.

to2012.<sup>155</sup> Croatia has a relatively low level of GHG emissions—one of the lowest levels among developed and transition countries. However, there is an issue of measurement of GHG as well as the scope for growing pollution from this source – see Chapter 8 for a detailed more discussion.

## **B. THE TRANSPORT SECTOR**

7.46 Harmonizing Croatia’s legal and institutional framework with the EU *acquis* in the transport sector will be conducive to increased efficiency and overall competitiveness. In particular, a growing role for the private sector will help reduce transport costs with obvious benefits for the process of regional and European integration.

7.47 Three parts of the SAA are of relevance to the Croatian transport sector: Article 58, Article 100 and Protocol 6. These lay down specific requirements for sectoral reform to the Croatian transport sector. These requirements are dominated by three general themes within the SAA:

- requirements relating to the greater liberalization of the transport sector;
- the provision of adequate infrastructure of sufficient quality;
- social, safety and environmental requirements relating to the transport sector.

7.48 This section will consider the progress that has been made so far and future reforms that will be necessary for compliance with the requirements of the SAA. In so doing, it will, where possible, examine the likely costs and benefits of making the necessary reforms, and propose recommendations that aim to minimize the costs and maximize the benefits of these reforms.

7.49 Although the discussion in Articles 58 and 100 concern all modes of transport, Protocol 6, where most of the substance of the SAA is to be found, refers only to issues relating to land transport. Therefore, this Report similarly concentrates primarily on issues relating to land transport.

7.50 In the analysis that follows, following an overview of the sector, in each subsection a transport sub-sector is covered providing first a brief institutional and reform background and focusing on the different issues that pertain to: institutional aspects, budgetary allocation (investment vs. maintenance, sub-sectoral structure of expenditures), adequacy of investment criteria, environmental impact, SAA compliance, taxes and pricing.

### **Overview of the Transport Sector**

7.51 The supply of transport infrastructure in most modes has increased in the last decade, sometimes extensively. In terms of roads, the most significant figure is perhaps the increase in the kilometers of motorways by over a third since 1995 (although there

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<sup>155</sup> See Ministry of Environmental Protection and Physical Planning (2001).

has been a smaller increase in the overall size of the road network). As motorways are expanding more rapidly, the overall increase in the size of the road network (28,123 km in 2000, up 4.4 percent since 1991) probably understates the overall increase in road capacity (411 km of motorways in 2001 compared to 36 km in 1995). In the rail sector, there has been barely any growth (2,726 km in 2000, up 1 percent from 1991) although there was significant electrification (almost 1,000 km over the decade) and a 44.5 percent increase in the number of stations throughout the 1990s. However, this is in a context where the average fall in the length of the rail network in the EU 15 has been 707 km per annum, and in the CEECs of 443 km per annum.<sup>156</sup> Air transport infrastructure has shown the biggest growth of any of the modes, measured either by the number of passenger seats (272 percent in 1991-2000) or net capacity of aircraft (261 percent). The only modes where the supply of infrastructure has actually reduced are inland water and maritime navigation, with both modes showing a reduction of one-third since 1991.

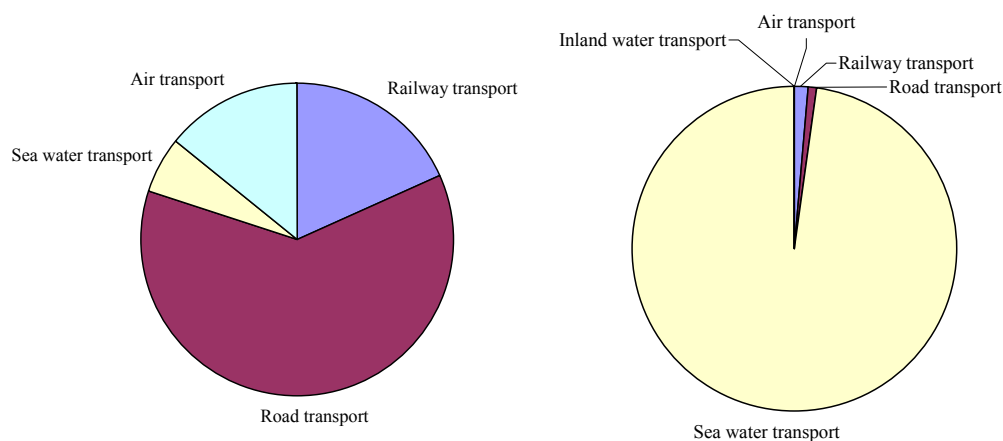
7.52 Interestingly, the pattern in the change in the supply of infrastructure is not clearly matched, in all modes, by the change in the demand for transport. Road vehicle registrations have clearly risen in the last decade, most significantly in terms of trucks, with a more modest growth in the number of automobiles and total vehicles, while the number of buses registered has actually suffered a decline. However, while the number of vehicles on Croatian roads has risen, vehicle densities, by international standards, remain relatively low. For instance, flow on the main trunk roads between the major cities (i.e., Zagreb, Rijeka, Osijek, Cakovec and Split) rarely exceeded 15,000 vehicles per day.

7.53 While road vehicle registrations have risen in absolute terms, the use of the railways is still considerably lower than at the beginning of the decade; passenger kilometers have fallen by a third while freight kilometers have fallen by almost 15 percent. While passenger kilometer figures have begun to improve in the last four to five years, figures for rail freight transport have either fallen or shown very little change. River transport figures have followed a similar downward trend throughout the decade. By contrast, demand for maritime transport has increased significantly throughout the decade, although the figures for freight transport have fallen off slightly in the last five years. The most dramatic growth in the period is in air transport, with a very substantial growth since 1991 in terms of both freight and passengers, with the rate of growth tailing off somewhat since 1995.

7.54 It is worth looking at the performance of the different modes in the last year for which data is available (Figure 7.2). It is clear that for passenger transport, measured in passenger kilometers, the growth in road transport over the last decade has led to it dominating this market. However, the dominance of roads in passenger transport does not compare with the dominance of maritime travel for freight transport, measured by ton kilometers, as shown in the second chart. The modal distribution of freight transport has seen very little change over the last decade. The only other mode of significance under this measure is rail transport.

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<sup>156</sup> European Communities (2002) 'Transport Infrastructure in the European Union and Central European Countries 1990-1999', Statistics in Focus Transport Theme 7 4/2002.

**Figure 7.2: Relative Modal Performance: Passenger and Freight Transport**

Source: Croatian Statistical Yearbook 2001.

7.55 The overall contribution of transport (with communications) to GDP is 8 percent, and the overall proportion of the national workforce employed in the transport industry is 7 percent.<sup>157</sup> This contribution to GDP is slightly higher than that of western European countries (Germany's contribution being 5.2 percent, Denmark's being 7 percent).<sup>158</sup> Similarly, the contribution in terms of employees is also slightly greater, the EU average being 6.5 percent. This is due to the U-shaped geography of Croatia which typically requires a more extensive transport infrastructure relative to similarly sized countries in South-East Europe. Another possible reason may be simply that there is scope or need for some rationalization of transport. However, other eastern European countries also show a tendency for the contribution of transport (with communications) to GDP to be above the overall average. The Czech Republic, for example, has a contribution of around 7.4 percent,<sup>159</sup> and Turkey's contribution in 2000 was very high at 14.2 percent.<sup>160</sup>

7.56 In terms of public expenditures made by the State, the breakdown for 1999 was: US\$768 million in terms of direct budgetary transfers, including US\$390 million for investment, US\$112 million for maintenance and US\$233 million for subsidies; US\$100 million as debt service; US\$125 million for guarantees to companies and through the transfer of risk from concessionaires; US\$30 million for the transport budgets for regional administrations and urban areas. This total, of approximately US\$1 billion represented almost 6 percent of GDP. This is very high by international standards; in the U.K. and France, the same figure is approximately 1.5 percent and even Poland has a similar figure. At the same time, as illustrated below, the much higher proportion of public expenditure devoted to the sector, leads to only a marginally higher contribution to

<sup>157</sup> Croatian Chamber of Economy (2001) 'Transport, Construction and Utility Services Department', July.

<sup>158</sup> UNECE (2001) 'Important Features of the Service Sector and Trade in Services in Transition Economies-Transport Services', June.

<sup>159</sup> Ministry of Transport and Communications of the Czech Republic (2000), *Transport Yearbook 2000*.

<sup>160</sup> International Monetary Fund (2002), *Turkey: Statistical Appendix*.

GDP. This would strongly suggest that such a high proportion of public expenditure would be inefficient. There are some encouraging signs that 1999 was a peak year—for instance the allocation of funds from direct budgetary transfer was expected to fall to US\$570 million in 2000. However, there are some worrying signs that the most inefficient forms of this spending may be steady or even increasing (e.g., operating subsidies increasing from US\$233 million in 1999 to US\$262 million in 2001).<sup>161</sup>

## Roads

7.57 **Background.** The responsibility for the management of the road infrastructure in Croatia is divided into three tiers. Hrvatske Autoceste (HAC), a joint-stock company, 100 percent-owned by the State, is responsible for the motorway network, except for that which is constructed or maintained by concessionaires, and is under the jurisdiction of the Ministry of Public Works, Construction and Reconstruction. Hrvatske Ceste (HC), also a joint-stock company, is responsible for the management of all other state roads—which constitute the vast majority of the network—and is under the jurisdiction of the Ministry of Maritime Affairs, Transport and Communication (MMATC). County and local roads remain the responsibility of the particular counties.

7.58 The Government of Croatia has a very ambitious program of investment planned for the road network for the period up to 2004 and beyond, averaging more than 2 percent of GDP per year. Much of this can be related to the requirements under the SAA. The individual components of this ambitious plan are:

- The Croatian Government intends to rapidly develop the motorway network in the coming years, so that in the next 10 to 15 years it will have increased by 1,330 km, with an interim target for 2005 of 850 km.<sup>162</sup> This would imply the motorway density would increase from 7.33 km/1,000 km<sup>2</sup> to 15 km in 2005 and 23.75 km by the end of the program. As a comparison, the average network density of the EU in 1999 was 15.8 km/1,000 km<sup>2</sup> and in CEECs 2.7 km/1,000 km<sup>2</sup>.<sup>163</sup> Of the €2 billion program envisaged for 2001-2005, over 75 percent, is devoted to the construction of the Bosiljevo-Split motorway connecting Zagreb with Split.
- In order to improve the present road network, the Croatian Government has undertaken to increase investment in maintenance of the existing public road network. In total, it is anticipated that €629m will be spent in the period 2001–2004 (or, on average €157.3m per annum), and that this will be divided roughly 75:25 between routine maintenance and periodic maintenance.

7.59 **High expenditures in Motorways/SAA compliance.** It is clear that there are very significant costs associated with the motorway program planned for Croatia to 2005, and beyond. To some extent, this reflects the requirements of the SAA. The latter has

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<sup>161</sup> World Bank (2001), 'Croatia—Regaining Fiscal Sustainability and Enhancing Effectiveness: A Public Expenditure and Institutional Review.

<sup>162</sup> Hrvatske Autoceste (2001) [http://www.hac.hr/Prezentacije/HAC\\_en.ppt](http://www.hac.hr/Prezentacije/HAC_en.ppt).

<sup>163</sup> European Commission (2001), 'European Union and transport Figures'.

three articles relating to the provision of road infrastructure. In these, there are two issues of particular importance:

- (a) That ‘*mutually coordinated measures to develop a multimodal transport infrastructure network as a vital means of solving the problems affecting the carriage of goods through Croatia particularly on the Pan-European Corridors V, VII, X*’ should be adopted. These corridors cover many of the construction projects, except those relating to linking Zagreb and Split.
- (b) In addition, the SAA also states that ‘*the development of a multimodal regional transport network on the Croatian territory which serves the needs of Croatia and the South-Eastern European region covering the main road and rail routes, inland waterways, inland ports, airports and other modes of the network is of particular interest to the Community and Croatia.*’ The construction of the Zagreb–Split motorway could be seen to be covered by such a requirement.

7.60 However, it remains necessary to express serious reservations concerning the motorway construction program. Given the dominance of the Zagreb–Split motorway, and the fact that this is not one of the Pan-European Corridors, this project is of particular concern. HAC has not used internationally recognized investment appraisal techniques. There was no assessment provided of the economic benefits (including externalities) that will be derived from the project, and consequently no evidence of the rates of return that can be expected from the project. In particular, despite it being explicitly stated in the SAA, there is no evidence of the Transport Infrastructure Needs Assessment (TINA) methodology (the EU form of cost-benefit analysis) being used to determine which projects should go ahead.

7.61 Croatia should use appropriate investment appraisal techniques to assess each of the motorway projects planned, prioritize those that do provide significant rates of return, including externalities (in excess of, say, 12 percent<sup>164</sup>), and postpone those investments that are not so economically advantageous. Within the analysis, existing contracts will have to be accounted for, and, in cases where projects have already commenced, future costs will have to be considered against some predefined rate of return.<sup>165</sup>

7.62 **Road maintenance – crowded out by motorways?** Due to a significant maintenance backlog, the present state of the network is well below an appropriate standard. Approximately 63 percent of the roads in Croatia are in good condition (road structure in good condition, pavement surface damaged up to 50 percent) compared to 95 percent or more in most large western European countries. The economic detriment caused by proceeding with the full implementation of the motorway program is likely to be acute. It is likely that some of this much-needed maintenance expenditure is being crowded out by the motorway construction program.

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<sup>164</sup> As suggested, in the World Bank Public Expenditure and Institutional Review, 2001.

<sup>165</sup> It should be noted that this could result in halting some projects; alternatively, some projects that would not have been approved before they began may nevertheless be deemed worthy of completion.

7.63 Although at an average projected rate expenditure in road maintenance of €157.3 million per annum, is higher than previous projections, it would appear that this level of spending is still somewhat lower than other studies have estimated would be efficient. For instance, previous World Bank studies identified respectively that overall maintenance expenditures should increase to US\$170 million (roughly the same in euros) per annum. Finally, at around one-third, the ratio on non-investment spending to investment spending is considerably lower in Croatia than in many other comparator countries; for instance, non-investment spending in the Czech Republic is 71.2 percent.<sup>166</sup>

7.64 *The Government of Croatia should evaluate present levels of maintenance expenditure to determine the economic benefits that will result, and also consider whether further economic benefits could be generated through a reallocation of spending. The Government should also consider the introduction of some form of incentive scheme for HC such that it is financially rewarded or punished depending on its performance in maintaining the road network.* Ideally, this incentive scheme would relate to the actual outputs of the road network, perhaps using the grading system currently employed. Basing the incentive scheme on the amount of spending, as is the practice in the U.K., is likely to lead to an inefficient use of resources.

7.65 **Institutional issues.** Although not a vital prerequisite in meeting the SAA requirements, the Government should consider reducing the number of agencies to one agency responsible for the entirety of the road program. Throughout Europe, the general model that prevails is one of a single body responsible for the entire road network. With multiple agencies in operation, resources can sometimes be inefficiently allocated, as may have occurred with the existing road program. In comparison, a single body may be better able to prioritize investment requirements.

7.66 There is an overlapping responsibility as well for road safety in Croatia. The Ministry of the Interior is the primary body responsible for road safety, both in terms of developing a nationwide strategy and also in terms of the collection of statistics. However, there also exists within MMATC, the National Road Safety Council. It is not clear that the relationship between these two bodies functions well and, as such, it may be impeding the delivery of effective road safety improvements. It also raises the question of the duplication of resources. *It is recommended that the Government consider which body is best suited to deliver the much-needed improvements in road safety. There is a wide range of organizational models that the Croatian Government can draw on, although it is noted that, in the majority of cases, the Ministry of Transport has a leading role,<sup>167</sup> and if responsibility was given to a single body then further improvement in road-safety performance could be expected.*

7.67 **Environmental issues.** At the time of independence, Croatia inherited a vehicle fleet that, by EU standards, was causing significant environmental damage. In recognition

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<sup>166</sup> Ministry of Transport and Communications of the Czech Republic (2000), *Transport Yearbook 2000*. Differing definitions regarding what constitutes investment is likely to make the figures not exactly consistent, but the magnitude of difference is sufficiently great that the overall point remains.

<sup>167</sup> See, for instance, OECD (2002) 'Safety on the Roads-What's the Vision?'

of both the environmental degradation, and of the higher EU standards, new policies have been introduced in recent years. First, all new vehicles are required to acquire type approval (a generic approval for all vehicles for a particular class). The approval mechanism is inspired by the EU *acquis* (Euro I and Euro II standards). The intention of the Croatian Government is to introduce the requirement for Euro III standards in 2003. Second, as part of the process to control vehicle emissions, tests have been incorporated. Such tests are required every year, except for new vehicles which have a two-year gap before the first test. In 2001, 48 percent of the cars tested failed to meet the required standards.<sup>168</sup>

7.68 While the testing of car emissions in this way represents a very positive step forward, the current high failure rate suggests that further progress would be desirable. There are a number of policies that the Croatian Government may wish to consider to induce this progress. First, it is generally the case that older vehicles tend to be more polluting than newer vehicles. To deal with this, in other countries, either retro-fitting or car-scraping policies have been implemented. In general, *car-scraping policies, where fiscal incentives are provided to encourage scrapping of high-polluting cars, and importantly, a bonus is provided for the purchase of a cleaner vehicle tend to be more cost effective*. Such a policy has been implemented for taxis in Mexico City and the bus fleet in Santiago. However, if failure to pass the emissions test leads to a vehicle being judged unroadworthy, road users may be tempted to doctor their vehicles to pass the test, while not actually reducing emissions. In order to counter this problem, the EU has announced (COM 1998, 117, final) its intention to make *random roadside testing* mandatory among member countries. If the present high rate of failure of the test does not improve in the next year, the Croatian Government should consider whether such a policy should be introduced in the near future.

7.69 **Fuel policy.** About 10 percent of fuel sales are leaded petrol; this is far more than what is required by the EU and what is desirable from a public health perspective. At present, the difference in prices ‘at the pump’ between leaded and normal unleaded is 11 percent, far less than would be desirable to induce greater substitution. Over time, *Croatia should prohibit lead in fuel (as in Hungary, Lithuania, the Slovak Republic and the Czech Republic). In the interim, Croatia should increase the degree of differentiation in the tax on leaded fuel to unleaded (e.g., in Estonia and Slovenia, the wedge is 15 percent) and introduce differentiation in taxes for different qualities of unleaded fuel.*

7.70 **Road charges.** Croatia has a fairly developed system of road charges: an excise tax on all motor vehicles ranging from 10 to 45 percent of the selling price of the vehicle; an annual motor vehicle tax for cars and motorcycles based on engine power and age of the vehicle; a capital transfer tax; motorway tolls which vary according to number of axles, height and in some cases weight; and fuel charges.

7.71 The EU publication ‘Fair Payment for Infrastructure Use’ advocates that charges for infrastructure should reflect the marginal social cost of use. Users should be charged

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<sup>168</sup> Croatian Vehicle Center (2002), ‘Exhaust Emission Test’, March.

for the costs, both internal and external, they impose at the point of use, when costs include operating costs, infrastructure damage costs, congestion and scarcity costs, environmental costs and accident costs. The benefits of introducing such principles are to internalize the external costs associated with road transport in order to prevent excessive use of the mode and to provide fair competition across the different modes to the benefit of potential transporters.

7.72 There are two issues that need to be considered when analyzing Croatia's road pricing policies in relation to these principles: the structure and the level of road charges. In terms of the *structure of charges*, it would appear that Croatia is already well on the way to creating a system in accordance with the principles set out by the EU. Nevertheless, there are some changes to the present structure of its road-charging policy that Croatia could consider, although these are not matters of immediate priority: the principle of toll charging on motorways could be extended to other main roads of the network; greater differentiation and sophistication could be introduced into the toll-charging system - the High Level Group on Transport Infrastructure Charging recommended tolls that vary by time and location; fixed annual charges for motor vehicles could vary more according to the technical characteristics and likely cost implications of the particular vehicle, such as fuel type, axle weight, safety characteristics.

7.73 In terms of the level of charges, the Ministry of Transport *should undertake a detailed study of the costs associated with use of the Croatian road network*. It is likely that such a study would suggest that changes would be desirable. The last study looking at the external costs of road transport suggested that, while cars were more than fully covering their external costs (by 135 percent), trucks and semi-trailers were only covering 25 percent of their costs.<sup>169</sup>

## **Rail Sector**

7.74 At present, the rail industry in Croatia is dominated by Hrvatske Željeznice (HZ), a vertically integrated, state-owned company responsible for both infrastructure provision and the supply of both freight and passenger services. The issues concerning the rail sector relate to two main areas: the provision of infrastructure and the restructuring of the sector. The plans for rail infrastructure development largely mirror those for road infrastructure development and have the same flaws: most investment is concentrated on development of the three Pan-European corridors, but with a unjustifiably large proportion devoted to enhancing the Zagreb–Split corridor.

7.75 Croatia's rail sector also needs to undertake two separate, but inter-related processes of reform. The first of these relate to the restructuring of HZ to enable it to meet the requirements of, and effectively compete in, the increasingly market-based environment in which the European railway operates. The second is the sector-wide

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<sup>169</sup> Rendel, Palmer and Tritton et al. 'Road User Charges Survey', 1996, taken from World Bank (1999), 'Republic of Croatia Policy Directions for Transport'.

reform that the Croatian rail industry needs to undertake in order to facilitate and/or promote competition between different operators.

**7.76 Allocation of expenditures.** In terms of the development of the Pan-European corridors, investments equivalent to €571 million are programmed for 2002-2006: €249 million in the Thessaloniki to Salzburg (via Belgrade, Zagreb and Ljubitiana) corridor; €201 million in the Budapest to Rijeka (through Zagreb) corridor; €121 million in the Budapest to Ploce (via Osijek and Sarajevo) corridor. According to HZ, these sums of investment will be used to build new lines, reconstruct and rehabilitate tracks, bridges and tunnels, provide new electrification, signaling and traffic remote control, invest in electric supply systems and telecommunications infrastructure and to invest in IT and environmental protection. In addition to these sums, a further significant project relates to the upgrade of the Zagreb–Split line, which is not part of the Pan-European network. The envisaged budget for this project is €224 million.

7.77 While the budget for railways is not as large as the budget for new road construction, it nevertheless constitutes a significant portion of GDP – on average 0.75 percent. The rationale presented for these investments, particularly on the upgrade of the Zagreb-Split line, are similar to the motorway program, namely increased tourist revenues. It is true that there has been a considerable infrastructure investment backlog in the last few years: depreciation rates have been twice as great as new investment in the period 1995–2000. Similarly, the societal benefits of establishing an effective rail network have been well recognized, especially by the EU. On the other hand, this has to be placed in the Croatian context where there has been a 33.7 percent reduction in passenger kilometers and a 14 percent reduction in rail freight transported since 1991. *Without a more rigorous analysis being applied, it is not clear that this particular investment program will be as economic as one, which, for example, included a greater proportion of maintenance spending.* Furthermore, it is pertinent to note that the SAA, notwithstanding its general commitment to promoting infrastructure development, states that it only expects Croatia to ‘prepare the participation of Croatia within the Trans-European Freight Network.’

7.78 Therefore, it is recommended that, before proceeding further with the planned infrastructure upgrades, Croatia uses investment appraisal techniques, in accordance with TINA methodology, to help ensure that any investments are economic,<sup>170</sup> and do not require long-term operating subsidies to support the expanded services. These considerations would naturally form part of any appraisal

**7.79 Reform of HZ.** HZ has been undertaking a number of reforms to improve its operating efficiency. Such reforms are desirable to reduce the reliance of HZ on the state budget. They will also become increasingly important if HZ is to successfully respond to

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<sup>170</sup> The TINA process was created to assist the development of an integrated transport network in Eastern Europe by establishing the priorities for future infrastructure needs, and examining how these may be funded. The underlying assumptions and aims of the TINA assessment include recognition of the importance of delivering ‘sustainable mobility’; pursuit of ‘projects of common interest’; elimination of bottlenecks; and the development of links to underdeveloped areas.

the pressures of an increasingly liberalized market. The process of reform of HZ has been carrying on for a number of years, beginning as early as 1993 with the separation out of non-basic activities such as rolling-stock production, the organization of integral transport and forwarding, and printing activities. Further reforms took place in 1998 with the separation of the hotel and catering facilities, transport of unit-load, and sleeping-car and wagon-restaurant services. Some improvements were indeed achieved: most notably, productivity within the company as a whole increased by 13.4 percent (measured by traffic unit per employee); the number of traffic units on the network increased by 9.7 percent over 2000 figures, which led to an increase in the revenues for HZ in absolute terms by 8.7 percent; and state operating budget subsidies for 2001 were reduced both from the figure in 2000 and from that projected in the plan – as a result, the Government operating subsidy as a proportion of total revenues is now 45.4 percent rather than the 49.8 percent envisaged in the plan.<sup>171</sup> Plans for company restructuring continued with the preparation for the separation of investment maintenance and building of infrastructure, maintenance and cleaning of administrative buildings, cleaning of wagons and security activities continuing from 2000. The actual separation and founding of new companies took place in early 2002. Nevertheless, it is evident that much more needs to be done. Productivity levels in traffic units per employee still remain at 50 percent of the 1989 level. And traffic units per employee (195,000 in 2001) are even below the 262,000 recorded for the Czech Republic and the Slovak Republic, 268,000 for Romania and 400,000 for Poland.

7.80 Ultimately, despite some recent improvements, HZ still remains overwhelmingly dependent on state budget subsidies for its continued existence. The Government's operating subsidy of 45.4 percent of revenues is high by international standards. This level of subsidy is equivalent to an operating ratio (operating costs divided by net sales, excluding government support) for the company as a whole of 164 percent. This compares with ratios in 1995 for the Slovak Republic of 113 percent, the Czech Republic of 127 percent and Poland of 116 percent. The Government has previously stated its commitment to ultimately privatizing HZ: this would be likely to have a significant effect on improving operating efficiency and harden remaining soft budget constraints. One significant step along this route could be to introduce further commercial reforms, including privatization, to the 'transport' business of HZ's operations, while leaving, at least for the meantime, the infrastructure business in public ownership.<sup>172</sup>

7.81 **Rail Industry reform.** Further reform may be needed to bring the country in line with the EU *acquis*. The essence of the *acquis* in this context is governed by the 'First Railway Package', consisting of Directives 2001/12/EC, 2001/13/EC and 2001/14 EC. The focus of these directives is to facilitate liberalization of the European network, especially for freight operators, by ensuring that all railway undertakings are dealt with

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<sup>171</sup> Although to a significant extent this is driven by an exceptional increase in other revenues, which it is forecast will not be repeated in future years.

<sup>172</sup> This model might be based upon the experience of Victoria, Australia, where exactly this model was followed. There is evidence that the restructuring and privatization of urban and non-urban and freight services has led to further improvements in performance. There is also considerable evidence to suggest that it is quite possible to retain public service obligations within a privatized operations side of the market.

on a fair and non-discriminatory basis. It is clear that there are already some signs of liberalization within the Croatian market: there is some competition between freight operators, especially on east–west routes, and there is also one foreign passenger operator, Optima, operating on one corridor. Further changes would be needed, including:

- The introduction of separate accounts and separate balance sheets for infrastructure and traffic operations and separate accounts for freight and passenger transport.
- The separation of functions so that bodies or firms that provide train operation services do not also make decisions on the licensing of railway undertakings, train path allocation, decisions on infrastructure charging and the monitoring of public service obligations.
- The creation of a regulatory body that at the very least can deal with complaints from railway undertakings regarding unfair treatment or discrimination in decisions over capacity allocation, infrastructure charging and the awarding of safety certificates. The regulatory body can, ‘where appropriate, on its own initiative, decide on appropriate measures to correct undesirable developments in these markets’ (Article 10 of Directive 2001/12/EC).
- The extension of access rights so that licensed international freight services can operate anywhere on the Trans-European Rail Freight Network (TERFN).
- The development and publication of a ‘network statement’ by the infrastructure operator containing information on the technical specifications of the network, access conditions and rules for capacity allocation (Directive 2001/14/EC).

7.82 HZ has already split its infrastructure and operations, although less accounting information is available regarding the split between passenger and freight operations. MMATC is working on a new Railway Traffic Act that would address the remaining of these requirements. In terms of point (2), one of the most significant changes that will have to be introduced is the explicit payment of track access charges by operators to the infrastructure division of HZ, on the basis of transparent and easily understood criteria. It would be very desirable to see that the independent body making the decisions referred to in point (2) is also the regulatory body referred to in point (3). This would ensure that the regulator is not merely an appellate body but is empowered to make decisions on its own initiative, granting it considerably greater power, and hence being a greater stimulus to competition. In terms of point (4), by only applying to the TERFN, it could be argued that relevance to Croatia is limited, as the railways are part of the Pan-European Network. However, introducing similar access rights to Croatia would provide a powerful incentive to improve the efficiency of HZ’s freight operations, which, as argued above, remain relatively inefficient by international standards.

### **Combined Transport**

7.83 Combined transport is defined by the EU as:

*the transport of goods between member states where the vehicle uses the road on the initial leg of the journey and, on the other leg, rail or inland waterway or maritime services where this section exceeds 100 km as the crow flies and makes the initial or final road transport leg of the journey.*

7.84 The present state of combined-transport flows in Croatia is widely considered to be unsatisfactory at present. There is only one company currently directly involved in combined transport in Croatia—Crokombi is 34 percent owned by HZ, 33 percent by road haulers and 33 percent by forwarders. In addition, Agit Ltd, a company wholly owned by HZ, is involved in organizing container terminals in Croatia; there is also a department within HZ responsible for the organization of tariffs and relations with neighboring rail administrations.

7.85 The SAA states that *‘The Parties shall take all the necessary steps necessary to encourage the development of combined transport.’* A large number of measures is suggested to meet this goal, including promoting the use of swap bodies, containers and unaccompanied transport; improving the speed and reliability of combined transport; increasing the frequency of convoys, reducing the waiting times at terminals, and increasing their productivity. However, if the increase in these flows is to be efficient it is vital that any increase is in response to market-led developments. The role for government intervention should be restricted to correcting any market failures. One particular role within this framework is to regulate the investment in infrastructure undertaken by private-sector companies in cases where those companies are dominant, or, only as a less desirable alternative, undertake that investment in the public sector. As such, there are a number of reforms that the Government of Croatia should consider to promote combined transport. *Customs reform and infrastructure development are the most important.*

7.86 HZ envisages undertaking both infrastructure and rolling stock investment in the next five years to encourage combined transport – €17 million in 2002-06. The infrastructure investment is to be directed primarily at developing areas for the transfer of containers, truck boxes and trucks, and the computerization of official centers. Arguably *as important as undertaking a specific set of rail investments is the progress that is made on rail restructuring.* A vital pre-requisite of allowing the market development of combined transport will be the effective restructuring of HZ and of the industry. The effective restructuring of HZ is essential for the development of a well-maintained rail network where track access and other facilities are efficiently priced and where investment is carried out to meet the needs of those involved in combined transport. The development and restructuring of the port of Rijeka, as discussed in the section below, will encourage greater use of the port and hence greater flows of combined transport.

7.87 Finally, combined transport operations involving Croatia are currently regulated under a regime of permits. This is a serious impediment to growth of combined transport as permits are limited and the process for acquiring one appears complex and protracted. Within the EU, quota systems and systems of authorization are explicitly outlawed. The Government of Croatia should seek to engage in bilateral and multilateral negotiations with neighboring countries, with equality of access and reciprocal arrangements

necessary in order to promote cross-border combined transport. Customs reform is important, with costs in terms of time as well as administration needed to be kept to a minimum.

### **Civil Aviation**

7.88 The SAA makes only limited reference to air transport in Article 58, referring to the development of ‘special agreements to be negotiated’ and the adaptation of laws ‘insofar as it serves liberalization purposes’. Nevertheless, a number of areas of reform are likely to bring economic benefits to Croatia.

7.89 Unlike other modes, there has been a significant increase in the demand for aviation services since independence; indications are that this growth will continue into the future. However, it is not clear that any increase in air travel will affect all airports equally nor that after it reaches the intensity of pre-war years, it would continue to grow fast. Despite this, the Croatian Government is planning very extensive investments in airport infrastructure, including the construction of regional airports on the islands of Hvar, Vis, Lastovo and Korcula; the reconstruction of the existing 10 airports in Croatia, including the reconstruction and extension of runways, reconstruction of taxiways and aprons, expansion of passenger terminals, adoption of terminal buildings and reconstruction of lighting system.

7.90 No costing data are available on these projects. However, it is extremely unlikely that all of these investments will be economically efficient, especially in those airports that (will) have relatively few traffic movements. Consider this: as a result of these investments, Croatia will have 14 airports. This compares with four in Hungary, 11 in the Czech Republic, three in Slovenia and seven in the Slovak Republic. Poland has 14 airports, but in 2000, there were 22 times more ton kilometers of freight moved than in Croatia, and eight times more passenger kilometers.

7.91 A second major investment that is being undertaken in Croatia’s aviation sector is the renewal of the life-expired air traffic control system. *This will ensure that the Croatia air navigation system will be fully integrated within the Eurocontrol framework.*

7.92 Regarding the airline sector, the Government suggested that there were tentative plans to undertake a partial privatization (similar to that of Air Italia). Although data have not been made available, concern has been expressed regarding the efficiency of the airline and its ongoing need for state support. It should be noted that in other transition countries, there are privatized carriers who, without receiving state subsidies, are very successful (e.g., Czech Airlines). This suggests that, at the very least, *Croatia should tackle the issue of the future of Croatia Airlines more urgently, and consider how a full privatization of Croatia Airlines could proceed.*

7.93 Finally, the plans to create an *independent Civil Aviation Authority* have stalled within the last year. Consistent with the principles that government involvement in the transport sector should be limited to create a market-based environment in which private

sector operators can compete fairly, and in which investors can have confidence, *this institutional reform should be enacted as soon as possible.*

### **Ports and Inland Water Navigation**

7.94 There has been a general decline of water borne transport in the last decade, with tons of goods transported by river transport falling by over 10 percent since 1995, and the capacity of the inland fleet falling by over 20 percent in the same period. Similarly, the tons of good carried by ocean-going vessels has fallen by around 15 percent, with the number of ocean-going vessels falling by over twice this rate, almost 35 percent, since 1995. The only exception to this trend is in passenger transport on ocean going vessels, which has risen by 17 percent since 1995 and 142 percent since independence. The nature of traffic has changed and there has been a steady decline in the quantity of goods coming into Croatian ports intended for other countries within the region—particularly as Serbia and Montenegro and Slovenia no longer use the Port of Rijeka and related land transport for their own exports and imports to any great degree. Economic restructuring has resulted in a reduction in the movement of heavy goods, a tendency towards roads and an increase in the importance of trade with western Europe. The 58 percent share of trade by mass that is channeled through ports is predominately an international business.

7.95 **Inland water navigation.** In terms of inland waterway transport, Croatia's policy, especially that of allowing cabotage for ships sailing under the Croatian flag, appears broadly in line with that of the EU. Furthermore, in terms of the technical standards for inland waterway ships, this process is currently controlled by the Croatian Ship Register, as legislated for by the Croatian Ship Register Act applying standards compatible to those required under Directive 82/714/EEC.

7.96 The main issue relating to the development of the inland water network is the extent of infrastructure investment that is efficient to undertake. Work has already commenced on upgrading the River Sava to Navigability Category IV. On top of this, there is a major project, waiting go ahead, for the construction of the Danube Sava canal, complete with the construction of a new port at Vukovar. The total cost of the project is estimated to be US\$1.5 billion, with the canal costing US\$780 million and the port the remaining US\$731million. In addition to this, there is a rehabilitation project for the Slavonski Brod Port planned, complete with the building of a new inter-modal terminal. It is estimated that this will cost US\$40 million. *There is no evidence that a satisfactory investment appraisal process has been carried out in the preparation of these projects.* Given the decline in inland waterway transport over the last five years, as documented above, it is probable that these investments are uneconomic and as such should not commence.

7.97 The construction of the Danube-Sava canal would take place as part of the upgrading of Corridor VII of the Pan-European Network to which Croatia is committed. To reiterate, Article 4 of the SAA states that the Contracting Parties:

*agree to adopt mutually coordinated measures to develop a multimodal transport infrastructure network as a vital means of solving the problems*

*affecting the carriage of goods through Croatia in particular on the Pan-European Corridors V, VII, X.*

7.98 The SAA, however, also envisages the use of TINA methodology, which would incorporate the externalities involved in completing a corridor, while the MoU between the European Commission and the various relevant governments discusses ‘undertaking studies ... using identical methods and technologies’, and that ‘the relevant studies should be carried out according to best practice’. Given this, *before the Government approves the project, it is recommended that a proper appraisal of the project is carried out, which should at least give some indication of the relative priority that should be afforded to it.* Unless externalities are large, the costs could vastly exceed potential benefits for Croatia.

7.99 **Maritime transport.** As such, reform of the maritime transport sector will be an important area of development for Croatia in forthcoming years. Although there has been a significant decline in maritime traffic in the last decade, the renewed peace and stability in the region suggests that there is potential for growth in shipping transport in the next few years. This potential is further enhanced by the improvement in land connections, such as new motorways, improvement in HZ efficiency and the progress that has been made in reforming customs operations, see below. In order to grasp this opportunity, the Government of Croatia has recently taken a number of positive steps, in particular: the rationalization of the port system, concentrating international traffic at Rijeka and Ploce; and the adoption of a new port law allowing for the involvement of the private sector in ports through concession agreements. As a result of this, there are signs that suggest that there will be a rejuvenation of maritime transport. At Rijeka, cargo traffic increased by 14 percent from 2.6 million tons to 2.9 million tons between 2000 and 2001, while at Ploce, the flow of goods in the period January–June 2002 was 12 percent higher than in the same period of the previous year.

7.100 There are a number of further improvements that the Government of Croatia should seek. In particular, at Rijeka port, a global 12-year priority contract was granted to Luka Rijeka to operate the port from 2000. However, there are a number of problems with Luka Rijeka, essentially related to its limited financial capacity, which is preventing the port from meeting international standards of performance. The limited financial capacity in turn is generated from low levels of activity, accumulated debt and overstaffing. In particular, Luka Rijeka at the end of 2000 had 1,518 employees, while external consultants estimate it could operate with around 900.

7.101 To address these problems, the Government has proposed *that Luka Rijeka be privatized during the length of the concession.* It is intended that this will be done through putting up for sale at least 51 percent of the shares of various daughter companies that will be created in accordance with the priority concessions. The new priority investors will be chosen on the basis of their ability to overcome the present problems faced by Luka Rijeka. However, one of the *significant problems inhibiting this process is the establishment of ownership rights at ports through amendments to the Maritime and Sea Port Law. This should be treated as a priority.*

7.102 Once this problem has been overcome, there will be a number of issues that will need to be resolved before the plan is executed, in particular *the design of the revised contract for the new concessionaires*. The Government of Croatia should follow international best practice in addressing contractual commitments, respective responsibilities (i.e., risk allocation), tariffs, and periodic review of performance.

7.103 Progress at Ploce port is slightly behind that at Rijeka, with no priority contract as yet being awarded. Port of Ploce Enterprise is currently in the process of transformation into a joint-stock company to enable it to apply for such a concession. However, if the problems at Rijeka are not to be repeated, it is vital that the award of the concession follows a transparent process with assessment against a range of established criteria.

7.104 There are 14 major shipping companies and a further 250 private ship operators in Croatia. Of these, Jadrolinija, the passenger service operator is the largest, and is 100 percent state-owned. As such, it is required to provide certain services for which prices are regulated, with losses being settled from the state budget. Aside from Jadrolinija, Croatian shipping companies are privately owned, although state institutions do hold percentage shares in a number of other companies. While Croatian and foreign shipping companies cover international passenger lines on the basis of reciprocity, it is expected that domestic lines are covered by Croatian shipping companies. Only if no domestic operator is prepared to cover a domestic line can a foreign company operate the line.

7.105 There are a number of policy reforms that the Government should implement, including: allowing free competition between domestic and foreign operators on domestic lines, in accordance with the SAA principle of 'no restriction' on competition; undertaking the privatization of Jadrolinija to enable new private sector investment to be realized; considering a gradual process of rebalancing of fares so that they cover the cost of providing particular services, in order to promote efficient operation.

## **Customs**

7.106 Trade development is vital for the continued growth of the Croatian economy. In the past five years, the volume of both imports and exports virtually doubled. As international trade increases, the importance of efficient customs practices becomes vital, both to reduce the costs associated with international trade and to ensure that legitimate taxes are collected and that smuggling is deterred. To this end, Croatia is participating in the Trade and Transport Facilitation in South-East Europe Program (TTFSE). The overall aim of the program is to promote more efficient and less costly trade flows across the countries in South-East Europe, and ensure EU-compatible standards.

7.107 The program has five components: customs services procedure reform; trade facilitation development; integrated customs information systems; improvement of roads and border crossing facilities; and program and project implementation. Progress on the Customs Services Procedures Reform began with the passing of the Customs Administration Law, in force since January 1, 2000, which draws on the EU *acquis*. Since then, focus has turned to the actual restructuring of customs practices. A recent report identified a number of positive trends emerging as a result of the restructuring

process. Productivity performance within Croatian customs is one of the best in the entire region. The ratio of total costs to revenue collected, at 1.59 percent, is also one of the lowest in the region. At the specific pilot sites, there have been some encouraging improvements in performance. In particular, at Jankonmir terminal, clearance timings have halved from five hours to three hours. At the same time, experience at this terminal has confirmed that, when inspections are reduced, the rate of detection improves.

7.108 However, it also identified areas with considerable room for improvement in performance, both at an aggregate level and at the pilot sites. In particular, there have been increases in average declaration costs, truck examination rates have increased to almost four times the target rates being set at 25 percent. As a result of this increase, detection rates have fallen to a practically negligible level. Given this mixed performance, there are a number of reforms that the Customs Directorate should undertake:

- The Directorate should make use of available software that allows for a comprehensive processing of data and intelligence, such as that used in Plovdiv (Bulgaria) or Grude (Bosnia and Herzegovina).
- In order to make more cost-effective use of scarce resources, Croatia should switch to a concept of dynamic border control, using patrols, inland checks and random checks at border points, in line with practice in EU countries.
- The relationship between customs officers and border police should be clarified as, at present, goods cleared by customs are often then subject to duplicate checks by border police. This has led both to increased border-crossing times and the undermining of morale of customs officers. The pay differential between customs officers and border police should also be addressed.
- The directorate's personnel policy should be carried out, considering in particular: the use of the 'systemization approach'; the prevalent use of relief officials; the appointment process for senior and mid-management positions; and the over-reliance on academic qualifications.

## **Conclusions and Summary of Recommendations**

7.109 In the introduction, three main themes of European integration were identified: infrastructure provision; liberalization and market access; and social and technical requirements. Progress has been made across all the modes in these three areas. In terms of infrastructure provision, Table 7.1 illustrates the main investments that Croatia intends to undertake in the next five to six years. The table identifies the projects, the extent to which they relate to SAA commitments, the total cost and, where known, the extent to which financing from international financing institutions (IFIs) has been secured.

7.110 Clearly, Croatia has planned a very significant investment program for the period up until 2005. However, a few high profile projects contribute significantly to this total without it being clear that they are required under the SAA. It would be desirable to apply

TINA methodologies to all of the prospective investment plans. At the very least, they should be applied as a matter of urgency to those projects not necessarily required by the SAA. The TINA methodology would facilitate comparisons across the different transport sectors and assist prioritization between them. One of the crucial results that this is likely to produce is a recommended scaling back in the road construction program.

7.111 In terms of allowing fair competition and establishing a transport sector based on market principles, Croatia has made much progress in recent years. Road transport is largely liberalized. Rail transport has made less progress to date. A key step will be for the new Rail Traffic Act to meet the main requirements of the 'First Railways Package' of the EU - in particular, the creation of a transparent set of non-discriminatory access charges and the establishment of an independent and powerful regulator. This will be an area to monitor carefully. Further progress on the restructuring of HZ will also aid this progress, and privatization of its operations arm should be considered in the near future. Competition in air transport would be improved by ending subsidies to Croatia Air and potentially privatizing it, following the successful model developed by the Czech airline. Finally, in terms of water transport, the present practice of allowing cabotage on Croatia's inland waterways is positive in terms of encouraging competition. However, the practice of giving preferential treatment to Croatian ship operators on domestic lines, and the widespread use of subsidies for Croatian shipbuilders should be discontinued.

7.112 In terms of inter-modal competition and road and rail pricing in general, Croatia should strive towards the principle of marginal social cost pricing. Conducive to this, the Government should undertake a comprehensive study of the external costs of road transport, using the methodology developed by the EU, and change its road pricing levels accordingly.

7.113 In terms of rail transport, the most obvious reform needed is the development of transparent, non-discriminatory track access charges. A combination of appropriate investments in ports and in the rail sector, along with the successful restructuring of HZ, will be the most important stimuli to the development of combined transport

7.114 In terms of social, technical and environmental standards, Croatia's recent program of legislative change draws heavily from the EU *acquis*. There remains, however, some areas of discrepancy in terms of road transport (e.g., axle loads, and, potentially, provisions relating to driving license conditions). In terms of environmental standards, the most important discrepancy relates to the continued sale of leaded petrol. This practice should be discontinued as soon as possible. A final issue relates to the fact that much of the environmental legislation only applies to new vehicles - consequently a number of policies to lower the average age of the vehicle fleet were put forward.

<b>Table 7.1: Summary of the Cost of Future Infrastructure Investments in Croatia</b>			
<b>Mode/Project</b>	<b>Relationship to Requirements</b>	<b>Total Cost (€M)</b>	<b>Extent to Which Financing From IFIs Has Been Secured (€M)</b>
<b>Roads</b>			
Links within Pan-European Network	Article 4 of Protocol 6	457	260 from EBRD and EIB (plus potentially a further World Bank equivalent of 5)
Other projects, notably, Bosiljevo-Split	Article 5?	1,617	None from IFIs
<b>Railways</b>			
Links to Pan-European network	Article 4 and Article 10 of Protocol 6	571.5	Most financing still to be arranged but €40m secured from EIB
Zagreb–Split line	Article 5 of Protocol 6?	224.3	None as yet
Combined transport investments	Article 9 of Protocol 6 of SAA	14.7	To be financed entirely internally
<b>Air transport</b>			
Reconstruction of existing airports and construction of new airports	Could be argued under Article 100?	No costings available	N/A
Replacement of air traffic control system	Articles 58 and 100 of SAA	45	25 from EBRD
<b>Inland water navigation</b>			
Construction of Danube–Sava canal	Article 4 of Protocol 6	Approximately 780	Financing still to be arranged, but support from IFIs to be sought
Construction of port at Vukovar	Article 100?	Approximately 740	As above
Rehabilitation of port of Slavonski Brod	Article 100?	Approximately 40	As above
<b>Ports</b>			
Riejka gateway project	Article 100	Approximately 259	Potentially, around 150
<b>Trade facilitation project</b>			
	Article 58	Approximately 21	Approximately 16.1
<b>Approximate totals</b>		4,769.5	491.1
Of which there is little uncertainty regarding need under SAA		2,148.2	491.1

Source: Croatian Statistical Yearbook, 2001,

## **8. ENVIRONMENTAL STRATEGY**

8.1 This chapter looks at the environmental challenges facing Croatia. Sizable investments are needed in the water, waste water and solid waste sectors where a substantial portion of the population still does not have access to public water and where environmental standards for waste water treatment and solid waste management are barely met. To bring environmental standards in line with EU directives, Croatia will have to step up its environmental reform and investment program.

8.2 The strategy for adopting EU standards on the environment is perhaps more complex than in other sectors. While declared national and EU environmental priorities are overall consistent, the benefit to cost ratio of the investments involved may not always be satisfactory over the short and sometimes even medium term. An appropriate strategic response will need to take into account the following factors. First, the level of investments that the State will need to fund however, is highly dependent on the speed of reform. Increased cost recovery mechanisms are not just a funding vehicle; by internalizing the costs on the environment they can induce substantial reductions in pollution, therefore in the needed mitigation measures. Furthermore, private sector participation can as well alleviate the burden to the State. Finally, investments can be phased with high cost-benefit ratio projects being undertaken first.

8.3 The chapter begins by outlining the environmental issues of importance in the country. It then provides an estimate of the investments in environmental upgrading required to adopt EU standards. These investment figures are, of course, not fixed. Apart from the considerable uncertainty underlying the estimates, the expenditure is also dependent on the policies pursued by the Government. The chapter looks at measures that can be taken to reduce or keep these investments to a minimum, especially those that will be borne by the public sector. These include measures to promote public and private sector partnerships, as well as the use of market-based instruments, special environmental funds and the like. Finally, the chapter reviews the current priority actions environmental program, as prepared under the National Environmental Action Plan, evaluates the extent to which it meets the objectives of the environmental *acquis* and discusses related institutional and policy requirements. Conclusions and policy recommendations are summarized at the end.

### **A. THE ENVIRONMENTAL SITUATION IN CROATIA**

8.4 Compared to the countries of Central Europe, Croatia is relatively well off as far as the state of its natural environment is concerned. However, heavy investments, particularly in the water, waste water and solid waste sectors are needed if Croatia is to meet EU standards. A snapshot of the status of the different sectors with implications for the environment is summarized below.

8.5 **Air pollution.** Most indicators point to a decline in emissions of the main air pollutants (by 15 to 50 percent) since 1990. Air pollution intensity of the economy has also improved substantially between 1990 and 1996 (see Table 8.1). Currently, Croatia meets the targets set under the Sulfur Protocol and the Multi-Pollutant Protocol to reduce emissions of SO<sub>2</sub> by 61 percent with respect to its 1990 level and to keep NO<sub>x</sub> emissions at the 1990 level. However, as the economy grows, action will be needed in the transport sector for NO<sub>x</sub> and in the electricity and industrial combustion sectors for SO<sub>2</sub>.

**Table 8.1: Air Pollution Intensity of Croatian Economy**

Year	000 Tons		GDP US\$MN.95	Intensity: GCP (US\$95)ton <sup>1</sup>	
	S02	NOX		S02	NOX
1990	180,000	87,600	25956	144	304
1996	66,200	68,600	22189	336	322
1997	80,400	73,300	23632	297	324
1998	89,500	76,000	24270	269	317
1999	90,700	76,600	24184	271	336
2000	58,100	76,800	25076	375	354

<sup>1</sup> Intensity is a measure of GDP in 1995 dollars per ton of pollutant.

Source: Ministry of Economy and IMF.

8.6 Local air pollutants are a concern in terms of ambient concentrations, which measure the quality of the air, and for which standards exist, nationally and internationally. Presently national standards are not met in a number of coastal settlements, although there have been notable improvements with respect to SO<sub>2</sub> and smoke in a number of urban areas. All in all, air quality has improved in Croatia in the last decade though problem areas remain. For instance, industrial centers in Sisak, Kutina, and Rijeka cause high concentrations of specific pollutants causing air pollution to exceed the limits allowed by Croatian regulations. Moderately polluted air can still be found in about 60 percent of inhabited areas in which the air quality is monitored especially due to suspended matter-particulates.

8.7 The most problematic issue that Croatia is committed to address with respect to air concerns carbon dioxide. Under the Kyoto Protocol Croatia is committed to reduce its emissions of greenhouse gases (GHGs) by 5 percent in relation to the base year (1990) over the period 2008–12. The Energy Strategy indicates that the Kyoto target is around 24 million tons of CO<sub>2</sub>; in 2000, CO<sub>2</sub> emissions were 20 million tons. However, it also indicates that under all scenarios this limit will be exceeded by 2010. Hence, some further measures will be needed. To meet the targets, Croatia may introduce a carbon tax (see below) and/or use Kyoto flexibility mechanisms. The Government needs to prepare a strategy for meeting this target.

8.8 **Water.** The key objectives are to extend public water supply to 90 percent of the population (it is 73 percent at present, with some areas completely uncovered), and wastewater collection to virtually the whole population (from the present 60 percent). At the moment, some 1,200,000 million inhabitants are still not connected to public water supply systems. Moreover, those who are connected do not always receive sufficient

volumes of drinking water, because many water supply systems have limited capacities which in critical periods cannot satisfy the needs for water in adequate quantities. A great number of existing water supply systems have limited volumes of water available, as a result of either insufficient capacities of water springs or incomplete or unsatisfactory construction of water supply facilities.

**8.9 Wastewater treatment (WW).** WW treatment is being expanded to meet EU norms in view of the importance of clean coastal water for the valuable tourism industry. There are also important international commitments that Croatia has to meet in reducing its nutrient loads into the Mediterranean Sea, which need some action on agricultural runoff. What policy should be pursued on non-point pollution, however, has yet to be determined. Finally, there are some concerns regarding contamination of sources of drinking water, especially in the Karst region (representing 30 percent of the territory). Massive levels of resources are required to achieve the much needed improvements in wastewater collection and treatment. Croatia will need to undertake innovative reforms in its water management and will need substantial external assistance to meet goals.

**8.10 Solid waste.** Solid waste management is also a major concern in Croatia. More than half the municipalities (comprising about 20 percent of the population) do not have organized collection and disposal of solid waste. The situation is improving, however. While generation is growing at 2 percent per year, collection is growing at 4 percent. This is being achieved in the face of considerable economic difficulties faced by most municipalities. Where waste is disposed of in dumps, only a few of them meet international standards. In Croatia, almost no solid waste has been disposed in an environmentally friendly manner. Thus, virtually all disposal sites need rehabilitation. Other problems that need urgent attention include the lack of adequate disposal facilities on small islands and improper disposal of part of the hazardous wastes that are generated. Policies are being developed to address these, inspired by EU regulations for landfills, recycling and reuse of materials. Financing alternatives include increased use of charges to cover the costs of many of the services that will have to be introduced.

**8.11 Agriculture-related environmental issues.** The National Environmental Action Plan (NEAP), which the Government put together in consultation with civil society and with the financial and technical support of the World Bank, mentions the problems of arable soil loss and problems associated with liquid manure and wastewater generated by intensive livestock breeding. On the institutional side, the cooperation between the Ministries of Agriculture and Environment seems to be weak. And information among farmers on applicable standards is very limited. The Government needs to increase resources to promote organic production.

**8.12 Other environmental issues.** Other issues deserving attention include: developing strategies for conservation outside protected areas, prevention of illegal land use, especially for construction, increased cooperation on transboundary problems (Black Sea, Kyoto Protocol, UNECE air protocols, etc.), treatment facilities for ballast waters and emergency response systems. All the above issues have been reviewed at some length in various documents, but especially in the NEAP.

## B. EUROPEAN INTEGRATION AND THE ENVIRONMENT – ESTIMATES OF INVESTMENT AND RECURRENT COSTS

8.13 There are no detailed estimates of the additional investment and recurrent costs to apply EU environmental standards in Croatia. There is only a general reference in the NEAP that investments will be in the region of **€1,500-2,000 per capita**. Total additional investments by sector were estimated in the NEAP as follows: solid waste (€2.6 – 3.4 billion), wastewater (€2.9-3.9 billion) and air quality (€0.6-0.8 billion), Industrial Pollution Prevention and Control (IPPC) (€0.14-0.8 billion) and other (€0.34-0.45 billion), making a total of €6.6-8.8 billion. A more detailed analysis of the costs has been undertaken, based on estimates for the countries of Eastern Europe, and on partial estimates for individual sectors in Croatia. The results are presented below.

8.14 The point of departure for the estimates is the European Commission study (EDC, 1997) of 1997, as well as later studies in which these figures have been revised for specific countries.<sup>173</sup> Based on estimates of investment expenditures for Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia, and the Baltic States, ‘best guess’ mean values, covering a period of 20 years, the total investment in these countries amounts to between **€860 and €1,720 per capita**.<sup>174</sup> The actual costs could be up to one-third lower or 50 percent higher, depending on how the investments are realized and what supporting policies are followed. The smaller countries appear to have slightly higher *per capita* investments, which is not unreasonable, as the EU environmental directives have a substantial ‘fixed cost’ element. Total investment for the water directives is close to that of the air directives and about 50 percent higher than solid waste directives. Estimates of the extra annual operating (as opposed to capital) expenditures that will be incurred are about **€80-120 per capita** for the group as a whole. Assuming that capital expenditures were to be spread equally over 20 years, annual outlays will be between 4 and 5 percent of present GDP – far more what CEECs currently spend

8.15 Using as inputs estimates both of NEAP and indirect estimates based on the findings of a study commissioned by the EC for CEECs reported above, Table 8.2 summarizes this Report’s own estimates. They are based on (a) expenditures for water and solid waste, based on primary data collected in this study; (b) expenditures for air quality, based on an average of the NEAP figures and an estimate derived from the *per capita* expenditures in the candidate countries, allowing for the relationship between the investment expenditures and GDP<sup>175</sup> found in those countries; and (c) expenditures on

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<sup>173</sup> The later studies come up with lower estimates (see Bucknall, Cestti and Damianova (1999) for Bulgaria, TME (1999) for Poland and the National Strategies for Lithuania. The actual detailed analysis for Poland, however, gives a figure quite close to the original study. The original studies excluded the costs of meeting the IPPC directives for industrial enterprises. The estimates for these directives in Table 8.2 are derived from data from Poland. The Polish data have been used to forecast the investments in other countries based on shares to GDP.

<sup>174</sup> See Table 2, A. Markandya (2002).

<sup>175</sup> The adjustment is approximate, based on a log linear regression between *per capita* costs and GDP.

IPPC and ‘other’ directives based on the estimates for the 10 candidate countries, taking account of the relationship between expenditure and GDP.

8.16 From Table 8.2, the overall base estimate of capital expenditure comes out with a range of **€6.1 to €11.8 billion, or €1,390 to €2,680 per capita**. The wide range is indicative of two things: uncertainty about the unit costs but, more significantly, differences reflecting how cost effective the investment strategy is. Below three scenarios are presented, giving the private and public investments as a function of the policies implemented in Croatia. The base case assumes slow reforms, the middle case assumes reforms broadly in line with a country such as Poland, and a high case assumes reforms in line with the Czech Republic.

**Table 8.2: Estimates of Environmental Investment and Recurrent Expenditures**

<b>Wastewater and water</b>	<b>Number of persons</b>	<b>Inv. cost per person €</b>	<b>Investment cost € million</b>	<b>Op. cost p. a. € million</b>	<b>Sector</b>	<b>Timing</b>
Settlements > 15,000	2,000,000	250-500	500-1000	30	Public-private	Years 1-10
Settlements between 2,000 and 15,000	1,500,000	500-1000	750-1000	22.5	Mainly public	Years 11-20
Settlements smaller than 2,000	1,000,000	500	500	20	Public-private	Years 11-20
Connections to Sewerage System	2,000,000	500-1250	1000-2500	10	Mainly public	Years 1-20
Public water supply	1,200,000	500-1000	600-1200	n.a.	Mainly public	Years 1-20
Total			3350-6200	82.5		
<b>Solid Waste</b>	<b>Amount of waste (tons)</b>	<b>Inv. Cost per M3 €</b>	<b>Investment cost € million</b>	<b>Op. Cost p. a. € million</b>	<b>Sector</b>	<b>Timing</b>
New landfills for household waste <sup>1</sup>	1,170,000	25-50	770-1540	50	Public-private	Years 1-5
Rehabilitation of old landfills <sup>1</sup>	7,000,000	10-35	350-1350	n.a.	Private	Years 1-10
Hazardous waste			11		Private	Years 1-5
Total			1130-2900	50		
Air Quality <sup>2</sup>			990-1550	n.a.	Mainly private	
IPPC and other <sup>3</sup>			600-1180	n.a.	Mainly private	
Total <sup>4</sup>			6070-11830	350-530		

1/ Operating costs are calculated at 5 euros/ton. Amounts are estimated in 2000 and it was assumed per capita waste would increase at 2 percent per annum.

2/ Numbers are an average of figures from the National Environmental Strategy and estimates from EU for 10 candidate countries.

3/ Estimates are based on per capita costs for 10 candidate countries and data from Poland.

4/ Operating cost estimates are based on EU studies for 10 candidate countries.

Source: See text.

8.17 These expenditures will be incurred over a long period – perhaps as much as 20 years. To assess how investments will be spread over time—given the lack of detailed plans—it is instructive to take the phasing of expenditures from the countries with a more advanced program and look at its implications for Croatia. For example, for Poland about 40 percent of total investments will be incurred in the first six years of the accession program, and of these about 30 percent will be funded by the State, 60 percent from non-state domestic sources and only 10 percent from external sources. The amounts vary a lot by category of expenditure. For quality of water the role of the State is higher than average. For IPPC programs and quality of air virtually all are funded from non-state domestic sources. For waste management the role of the State is also greater than average. These figures<sup>176</sup> were used in the next section to derive estimates of the investment's requirements time profile for Croatia.

### C. INVESTMENT NEEDS OVER TIME AND AS A FUNCTION OF REFORM SCENARIOS

8.18 The three scenarios referred to above—base reform, medium reform and high reform—are described in Table 8.3. The policies affecting simulated investment needs, including cost recovery profiles, are listed below, with a brief description of how they vary across scenarios. The objective is to achieve overall efficiency in the investment program. From a social point of view this stems from low cost projects with large benefits. The key issue is not whether the private sector or the Government pays less but that society as a whole pays as little as possible and it is this consideration that drives the reform scenarios described below.

- (a) **Pricing of utility services.** Presently, charges to users for water supply/waste water are mostly based on volume, but revenue sources remain insufficient to cover the full costs of the services. At the same time the efficiency of municipal water companies is low. For solid waste collection and disposal practically all municipalities charge on the basis of living area of the housing unit. Although charges now generally cover the collection, removal and disposal costs for solid waste, this is true only when the disposal facilities do not meet the environmental and sanitary standards. An increase in charges, when enacted so that users pay based on level of use, will result in a decline in demand and therefore a lower level of needed investment. *In the base case, progress to full cost recovery is assumed to be slow but continuous. In the medium scenario progress is more rapid, and some efficiency increases in the municipal companies is assumed. Finally in the high reform scenario, the move to pricing that recovers costs is much more rapid and efficiency gains in municipalities is greater.*
- (b) **Use of Market-Based Instruments (MBIs).** The expenditures required to meet the environmental objectives will be lower if the rate of implementation of MBIs to provide polluters incentives for reduced

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<sup>176</sup> Markandya (2002), Table 4.

emissions is greater. These instruments reduce the environmental burdens and thereby the need for investment in the treatment and disposal of these burdens. They also provide some resources for the public sector to pay for the clean-up.<sup>177</sup> The latter depends on the use of taxes and charges as regulatory mechanisms, which are becoming increasingly used in the EU countries.<sup>178</sup> There is considerable potential for the use of such instruments, but there are also important issues of design and application that have to be addressed and not all environmental charges have worked well.<sup>179</sup> Some pollution charges already exist in Croatia (e.g., the water effluent charge) but it is not effective in reducing emissions, partly because the level is so low and partly because of serious difficulties with collection. *The key areas where charges have a serious potential and are feasible are the carbon tax, a hazardous waste charge and product charges. In the scenarios developed here the use of MBIs is assumed to progress slowly in the base case, with some new instruments being introduced and a carbon tax becoming effective only in 2006 with substantial exemptions and a low rate of charge. In the medium scenario, the MBIs are introduced more aggressively, with a carbon tax being effective as early as 2004. In the high reform scenario, the tax is brought into effect in 2004 and the rate increased slowly over the next five years.*

- (c) **Private sector participation in the Water Sector.** The main responsibility for water management is with Croatian Waters (HV). Although HV is legally a commercial organization, it effectively operates as an arm of the Government. The Government is seeking to reform the institutional role of HV through the corporatization of water supply services, the reform of the sector towards regional wastewater management, and the participation of the private sector in the financing and management of wastewater treatment facilities through a variety of mechanisms. The results of these changes are just emerging: a new concession is being given to the Zagreb WWTP, which is being privatized under a 25-year BOT; the World Bank is supporting a US\$250 million project over the next six years covering a number of coastal municipalities; and a new Public Private Partnership project - the Poreč WWTP - will be realized without the financial guarantees of the municipality (the foreign private companies will ensure the financing and knowledge transfer). The key sticking issue for private sector involvement remains, however, the affordability of the systems by the communities they serve. Some form of public private partnership is most likely the way

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<sup>177</sup> Examples of studies showing the benefits of using MBIs on the level of investment in the transition countries include Hughes and Bucknall, 1999, TME, 1999, World Bank, 1999 and Markandya, 2002.

<sup>178</sup> Table 6 in Markandya (2002) provides a description of the main environmental market-based instruments in use in the EU, the potential role they play there and the scope for their use in Croatia.

<sup>179</sup> The use of emissions charges is widespread in the CEEC and former NIS countries, with the revenues being earmarked for environmental protection through environmental funds. This issue is discussed further below.

forward in this sector. *In the scenarios presented in Table 8.3, the base case assumes that the private sector's role will remain small – at about 10 percent of total supply and that financing will accordingly have to come predominantly from the public sector. In the moderate reform scenario, it is assumed that the private sector will achieve 23 percent, about what has been achieved in Poland. In the high scenario, a higher level of private participation is envisaged – around 30 percent.*

- (d) **Private sector participation in solid waste management.** On solid waste, a national strategy is being prepared but its level of harmonization with EU Directives should be improved. Furthermore, few investment estimates have been prepared and the role of the private sector is being developed for solid waste quite slowly. Privatization has been largely limited to the Northern areas, with some recent development in coastal zones on a concession basis. Most collection and disposal is undertaken by local authorities and recycling programs are limited. One case where a PPP project is being implemented is in Poreč where two old landfills have to be rehabilitated and one new one will be constructed, according to EU standards. The joint company established will also provide municipal solid waste disposal services. The State does not have an organized system for hazardous waste and the levels of most hazardous waste generated are unknown - there is no special charge or tax for hazardous waste yet. *For the scenarios, the base case assumes that the private sector will have some enhanced role compared to today, but with a limit of around 25 percent of total investment. In the medium reform scenario, the level expected in Poland for the private sector is assumed to be achieved (43 percent) and in the high reform scenario the share of the private sector is assumed to go up to 60 percent. In the medium and high reform scenario recycling will reduce the amount of waste generated, more so in the high reform.*
- (e) **Private sector participation in the Energy Sector.** With regard to air pollution, the main burden of meeting the expenditure requirements will fall on the energy sector and the oil refining sector. The greater the share of that sector that is not under state control, the smaller will be the demands on state resources. The Government's energy strategy recognizes that progress in this area towards privatization and competition may be slow and draws up scenarios with different speeds of reforms - data on *investments* under each scenario was not available. Thus, estimates of private sector investment are speculative. *In the case of Poland, almost all investment in this sector comes from the non-state sector, and it is assumed that this will hold in Croatia as well, under the medium and high reform scenarios. In the base case, however, partial privatization of HEP is achieved in 2003, but further progress is delayed and only 50 percent of investment is made by the private sector.*

**Table 8.3: Scenarios for Implementation of Environmental Investments for the *Acquis***

Policy	Scenario		
	Base case	Medium reform	High reform
Pricing of utilities' services	Slow progress towards cost recovery in water and waste sectors	Moderate progress towards full cost recovery and some volume-based pricing.	Rapid progress to full cost recovery and volume-based pricing
Use of Market Based Instruments	Existing charges on effluent continue and new charges on carbon, some products introduced slowly at low rates	Existing charge levels raised and new charges introduced more rapidly at higher rates	Existing and new instruments introduced rapidly, with rates that have incentive effects.
Private sector participation in water sector	Very limited participation of private sector, investment limited to 10% of total, only current projects implemented	Moderate participation, with investment going up to 21% of total.	Substantial participation, with investment going up to 30% of total
Private Sector in waste management	Very limited participation of private sector, investment limited to 25% of total, only current projects implemented.	Moderate participation, with investment going up to 43% of total. Some recycling programs effective	Substantial participation, with investment going up to 60% of total with significant recycling programs
Reforms in energy sector	Scenario S421, with slow reforms. Only 50% of investment is in the private sector.	S422, with faster reforms. Almost all (>99%) investment is from the private sector.	S423, with increased penetration of renewables and incentives to reduce greenhouse gases. Almost all investment (>99%) is from the private sector.
Reforms in industrial Sectors	Large scale privatization of industry proceeds slowly and private sector share of investment is 75%	In both these cases the share of private sector investment under the IPPC is the same as planned for Poland – 93%	

*Source:* World Bank staff.

- (f) **Reforms in Industrial Sectors.** The main investments here would arise from adopting the Integrated Pollution Prevention and Control Directives that mandate the use of 'Best Available Technologies' in industrial processes. Naturally, these are expected to be introduced over time, but the

overall cost is substantial - between €600 and €1,200 million. The bulk of this should be undertaken by private *industry* but that depends on the rate of privatization, especially in the large scale industries.

- (g) **Timing of investment.** An important factor that will determine the investment needs in present value terms and in terms of the actual outlays in the first six years or so is the timing of the investments. The *present* value of the investments will fall if the more expensive items are delayed. Studies commissioned by the EC show that a careful assessment of the benefits against the costs supports an upfront adoption of most of the air pollution related standards, and a more careful phase-in of waste management and waste water treatment standards.<sup>180</sup> An example where a longer phasing of investment would be justified is wastewater treatment by municipalities, especially in the many coastal towns where the waters even now are of excellent quality for bathing and shellfish cultivation and where further wastewater treatment is not necessary. There are, however, a number of ‘hot spots’ where this is not the case and where further tourism development will further aggravate the situation if corrective action is not taken. In summary, therefore, timing of action should be determined by the relative costs and benefits of the proposed measures. *In drawing up the reform scenarios, it is assumed that **in all cases**, the Government will pursue an effective phase-in, based on the analysis of benefits and costs and on considerations of the availability of local financing.*
- (h) **Design of investment and procurement rules.** The required expenditures are also sensitive to the efficiency with which municipalities take investment decisions. Opening up procurement to international tender and undertaking careful project appraisal in evaluating the design of the schemes will reduce costs significantly. In designing the investments, account should be taken of lower demand for some services when future service charges will have to recover capital and operating costs.
- (i) **Other factors that influence the integration program – development and availability of human and institutional capital.** The above discussion has hinted at the importance in the overall program of adequate human resources to carry out the substantial increase in work associated with it. Primarily, the additional burden will fall on the Ministry of Environment but a major additional part will have to be played by the Ministries of Agriculture, Energy, Industry and Transport. Staff will need to be trained so that they are familiar with EU standards and how they work, as well as being brought up to date on the new regulatory systems being introduced to handle the larger private sector role in service provision. No direct estimate of the resources has been made or was available from the Government.

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<sup>180</sup> For details see Ecotech (2001).

## Reform Scenarios – Investment Needs

8.19 In quantifying the impacts of these policies it is assumed that in the base case the costs will be at the upper end of the estimates provided in Table 8.2. In the medium reform scenario, they will be at the average of the Table 8.2 estimates and in the high case, they will be at the lower end of the estimates. As far as the share of private versus public expenditures is concerned, this follows directly from the numbers given in Table 8.3. The resulting estimates for investment in the first six years is given in Table 8. 4.

8.20 Total costs fall with the reforms. Over the first six years of integration, in the base case scenario, investments could mount up to as much as *€4.8 billion*, whereas in the *high reform* scenario, they could be as little as *€2.4 billion*, i.e., half the maximum figure. *Recurrent expenditures* are estimated to be in proportion to the investments - between *€140 and €275 million* over the same period. The percentage that comes from the public sector varies by even more than that. In the base case, the *public sector* will have to spend around *€2.5 billion* but in the *high reform* scenario, the investments are around *€810 million* – or one-third of the total. The major share of public expenditure in all cases is in the water sector – just over half the total. Non-state expenditures are highest for the IPPC directive in all the scenarios. External funding (EU, IFIs) in the base case scenario is about *€1.2 billion*; it declines to *€730 million* in the medium scenario and to *€400 million* in the high scenario.<sup>181</sup>

## Investment Needs Over Time

8.21 The investments for the first six years can be allocated to individual years using the time profile from Poland, where the expenditures build up over the period, starting with a relatively small amount in the first years. Taking the relative profile of Poland and applying it to Croatia would give annual values for public expenditure and total expenditure respectively as shown in Table 8.5. This table shows that public outlays increase from between *€76 million* (high reform) and *€233 million* (base case) in year 1 to between *€169 million* (high reform) and *€516 million* (base case) in Year 6.

8.22 Total expenditures in Year 1 are between *€275 million* and *€553 million*, rising to between *€470 million* and *€940 million* in year 6. If these levels of expenditure are compared with the actual spending on the environment from state and non-state sources we find that in 1999 (last year for which we have data) investment on environmental protection amounted to *€35 million*.<sup>182</sup> In addition, about *€23 million* was spent on current environmental expenditures. Thus, even to get to the initial year of the candidate program, Croatia would need, even in the best scenario, to increase total annual spending by more than *€200 million* and public spending by at least *€40 million*.

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<sup>181</sup> It is important to recall that the reform scenarios are only indicative of the likely investment needs. Investment estimates draw largely on figures from countries that are close to Accession and the impacts of the reforms on the costs in great part are judgmental. Croatia may not follow exactly the same profile, and indeed it should seek to shift as much of the cost burden to the non-state sector as possible.

<sup>182</sup> No data are available on non-state spending and only patchy information on external spending not included in the *€35 million* figure.

**Table 8.4: Environmental Acquis Expenditures for Croatia for the First Six Years (€ million)**

<b>Base Scenario</b>		<b>First Six Years' Investment Expenditures</b>			
<b>Category/Source</b>	<b>State</b>	<b>Non-state domestic</b>	<b>External</b>	<b>Total inv. years 1-6</b>	<b>Total cost (whole period)</b>
Quality of Water	1466.5	119.7	808.4	2394.7	6200.0
IPPC and Other	189.7	569.0	0.0	758.7	1180.0
Quality of Air	56.5	135.9	79.5	271.9	1550.0
Waste Management	769.6	347.1	271.6	1388.4	2900.0
Total	2482.2	1171.8	1159.6	4813.6	11830.0
<b>Medium Reform</b>		<b>1st Six Years' Investment Expenditures</b>			
<b>Category/Source</b>	<b>State</b>	<b>Non-state domestic</b>	<b>External</b>	<b>Total inv. years 1-6</b>	<b>Total cost (whole period)</b>
Quality of Water	1070.0	184.4	589.9	1844.3	4775.0
IPPC and Other	40.1	532.2	0.0	572.2	890.0
Quality of Air	0.9	220.5	1.3	222.8	1270.0
Waste Management	414.8	410.1	139.8	964.7	2015.0
Total	1525.8	1347.2	730.9	3603.9	8950.0
<b>High Reform</b>		<b>1st Six Years' Investment Expenditures</b>			
<b>Category/Source</b>	<b>State</b>	<b>Non-state domestic</b>	<b>External</b>	<b>Total inv. Years 1-6</b>	<b>Total cost (whole period)</b>
Quality of Water	625.6	323.5	344.9	1293.9	3350.0
IPPC and Other	27.0	358.8	0.0	385.8	600.0
Quality of Air	0.7	171.9	1.0	173.7	990.0
Waste Management	159.9	324.6	56.5	541.0	1130.0
Total	813.2	1178.7	402.3	2394.3	6070.0
<b>Memorandum Item</b>					
<b>Recurrent Costs</b>					
Base Scenario	141.8	67.0	66.3	275.1	676.0
Medium Reform	87.2	77.0	41.8	205.9	511.4
High Reform	46.5	67.4	23.0	136.8	346.9

Recurrent costs are taken as 5.7% of capital costs based on previous Accession studies.

Source: See text.

**Table 8.5: Annual Investment Estimates for Croatia (millions of euros)**

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>
State Base Case	233.1	304.5	450.7	473.8	503.0	516.1
State Medium	143.3	187.2	277.1	291.2	309.2	317.2
State High Reform	76.4	99.8	147.7	155.2	164.8	169.1
Total Base Case	552.8	648.9	841.6	887.3	934.6	943.1
Total Medium	413.9	485.8	630.1	664.3	699.7	706.1
Total High Reform	275.0	322.8	418.6	441.4	464.9	469.1

Source: See text.

### **Fiscal Impact of the Environmental Investments Required for European Integration**

8.23 In 2001, the Government's total expenditure amounted to €7.5 billion of which spending on the environment represented about one half of one percent of public expenditure. If the higher level estimates above are to be met, the level as a percentage of total expenditure will, in the medium reform scenario, remain around 2 percent in the first year rising to about 4 percent in the sixth year. With the base case scenario, these figures are higher.

8.24 With a higher rate of growth, the overall costs increase, as demand for some services, such as energy and transport, increases. However, other services such as water do not increase proportionately and so the total increase is less than the growth in national income. Hence, if countries can pursue a successful growth strategy, they will be more able to meet the costs in the future, when that strategy has been realized.

### **Environmental Funds – Pros and Cons**

8.25 An Environmental Fund will be created in 2003 (The Law on the Environmental Protection and Energy Efficiency Fund is now in the third reading in Parliament). In the CEEC and CIS countries, the results of using environmental funds have been mixed. While they can be a useful source for the financing of environmental investments, there have been questions on transparency of procedures and efficiency of allocation of the funds. They have been responsible for large levels of investments but the use of state-of-the-art techniques to assess cost effectiveness and to estimate the social benefits of different investments is often lacking. The instruments used include direct grants, soft loans, 'green equity' investments, interest rate subsidies on semi-commercial loans. However, the 'subsidy equivalent' to each party is rarely calculated, making any cost effectiveness exercise very difficult to achieve. The Croatian Environment Fund should do its best to avoid these problems by working out procedures for evaluating environmental projects jointly with the European Commission and the IFIs.

8.26 The Government has agreed to transparently incorporate the Fund into the 2004 budget as a budgetary fund. In the context of the transition from centrally planned economies such funds are seen as a useful vehicle for ensuring that the environment receives at least a minimum allocation of resources, but there is less justification for retaining them once stability has been achieved. One of the concerns is that enterprises will seek legal exemption from payment of 'pollution charges' if the same are not imposed on competitors in the Union. In that case the revenues of the fund will disappear. Croatia should be aware of these risks and plan its Environment Fund with them in mind. To limit prospective difficulties, some form of 'sunset provision' should be included in the proposed fund.

### **D. SAA REQUIREMENTS AND THE NEAP – CONSISTENCY AND ACTIONS TO DATE**

8.27 The SAA has a number of environmental measures, principally establishment of legal frameworks and laws that are consistent with those of the EU. To date, Croatia is

making progress in implementing them.<sup>183</sup> Croatia has also been timely in its ratification of all the major environmental conventions and is currently in compliance with them. These include European air pollution conventions, the transboundary watercourses and industrial effects conventions, the Basle Convention on transport of hazardous wastes, and the CITES convention on trade in endangered species. The Aarhus convention on public participation has been signed but not yet ratified. *The need now is to support this with development in institutional and human resource capacity, so that the legal measures can be implemented effectively.*

8.28 The NEAP, on the other hand, intends to cover short and medium-term priorities in the environment field and is accompanied by a Priority Action Plan which lists projects that must be started in the next two years and completed in the next five. This list was prepared in January 2002 and covers the next five years with particular focus on the next three. Overall expenditures for the NEAP amount to €688 million, 88 percent of which are for air, water and waste management.

8.29 Compared to the estimates reported in Table 8.5, the NEAP program, even if it is entirely devoted to meeting EU environmental standards, will meet between a half and a quarter of the total investment for the first five years. The discrepancy is even starker in that firm funding is only available for a small part of the NEAP program. *Thus, meeting EU environmental standards will require a major expenditure adjustment in the Environmental Strategy which, in turn, will require an acceleration of the reform agenda so as to minimize the fiscal impact of the program.*

8.30 The funding levels involved in meeting EU standards may be different from those envisaged in the NEAP, but apart from some of the air pollution programs, the priorities are essentially the same.

8.31 **Waste management.** Setting up the institutional and legislative framework for the waste and packaging directives does not impose a major investment expenditure on the country at the present time. The solid waste-to-energy plant for Zagreb is a high national priority but not relevant to meeting EU standards. The rehabilitation of the incinerator for hazardous wastes is a high priority from the point of view of meeting EU standards and even higher from a NEAP viewpoint. In general, there is no major initiative that is not a NEAP priority and that is being carried out to meet EU standards. The total investments on these projects is €123 million.

8.32 **Water management.** The present selection of waste water pollution control projects under the NEAP are also all actions that would be necessary under the EU directives. The NEAP has not provided all the relevant investment data and hence the figure of €114 million given is only a partial estimate of priority actions - investment estimates for the Water Sector to meet EU standards is under preparation.

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<sup>183</sup> For a detail of compliance with the legal and administrative requirements, see Table 9 of Markandya (2002).

8.33 **Air pollution.** The lead phase out is both a key area of congruence. The state oil company INA is being privatized and has to upgrade its facilities to produce lower sulfur, higher quality oil if it is to be commercially viable. Hence, EU standards and NEAP objectives also coincide here. The total investment of €452 million is partly met from the private partnership projects, thus reducing the burden on the state budget. Areas where conflicts may arise are in the upgrading of the thermal plants for reductions in SO<sub>2</sub> emissions from fuel oil.

8.34 **Soil and forests, biodiversity, coastal zone management, institutional capacity and risk and accident management.** While there are substantial programs in all these areas, total investment is relatively modest - €98 million. Most of this is for 'institutional strengthening'. In general, little needs to be done to meet EU standards that would not be done irrespectively.

## E. POLICY RECOMMENDATIONS

8.35 The environmental challenges facing Croatia are moderate when one looks at the physical environment. Although there are some areas where urgent action is needed, they are relatively few and the problems are, by and large, manageable. Probably the most serious problems facing the country are those of water and waste - extending water supply, increasing wastewater collection, better managing solid waste disposal and illegal land development. The most problematic from an international point of view are those related to greenhouse gas emissions: action is needed if Croatia is to meet its international obligations with respect to the Kyoto Protocol. Finally, there is a need to strengthen the institutions that are responsible for managing the environment. This will be even more important as more and more sophisticated EU standards are introduced.

8.36 The more serious and difficult problem is for the country at the present time to upgrade its environmental infrastructure so that it is in line with EU standards. Experience from accession countries is compelling in its evidence that each future EU member will need to invest a lot more than it normally does in environmental protection. This chapter has reviewed the estimates and concludes that Croatia will have to invest an additional 5 to 10 billion euros over a 20 year period to bring its environmental standards up to EU levels. About half of this will be in the water sector and the rest will be divided between solid waste, air quality and IPPC directives. There will be significant operating costs to take into account. Estimates indicate that these will be of the order of €80-120 *per annum per capita*.

8.37 The estimated range of investments is wide mainly because the actual costs are sensitive to the policies in place for environmental regulation. Volume-based pricing for water and solid waste can play a major part in reducing the services demanded and thereby reducing the investments needed to supply them. Likewise, the use of market-based instruments such as a CO<sub>2</sub> emission charge and product charges on items that are costly to dispose off will have a reducing effect on the demand for fossil energy and the generation of the waste. The charges will also provide funds to invest in energy efficiency and tackle the disposal of the waste. The other reforms that are critical to keeping the public sector investments down are those that enhance the role of the private

sector in the delivery of the services. Finally, careful assessment of the benefits and costs of required investments will allow the policy makers to negotiate a delay in implementing those that have high costs relative to benefits. Typically, these turn out to be the air directives as well as water supply and solid waste directives.

8.38 Investments were estimated under three alternative reform scenarios. The base case assumes slow reforms from the status quo, the medium reform scenario assumes more rapid increases in utility charges and in private sector involvement and the high reform assumes reforms that take Croatia to the level of the most advanced candidate countries, such as the Czech Republic. The results show that total investments can be reduced by a factor of two from the high reform to the base scenario. Even more importantly, however, public sector investments fall by a factor of three. In the base case, the State will have to spend something like €2 billion in the first six years; with the high reform scenario it will have to spend only about €700 million.

8.39 Even with the lower levels of state spending, however, the level required in the first few years will be more than double current state spending on the environment. Although even these higher levels of environmental investment are small relative to the overall public sector budget, a substantial increase in the environmental part of the budget will be a challenge given the necessary fiscal consolidation outlined in Chapter 2. This has to be planned for, including the institutional strengthening that will be needed in the Ministry of Environment.

8.40 The Government proposes the establishment of the Environmental Protection and Energy Efficiency Fund to help fund integration costs in the area of the environment. Environment funds can play an important role provided they are not extra-budgetary and provided the recommendations of implementing acceptable investment criteria and transparency are followed. It is also important not to see the funds as permanent institutions but as transitory, providing urgent funds to meet key investment needs until new environmental practices are firmly entrenched in the mainstream of government operations.

8.41 Croatia is making progress in implementing measures required by the SAA. Most of these measures are either administrative or legal. More generally, Croatia has also been timely in its ratification of all the major environmental conventions and is currently in compliance with them. The need now is to support this with development in institutional and human resource capacity, so that the legal measures can be implemented effectively. In general, there do not appear to be any major conflicts between the EU standards and the NEAP objectives as articulated in the NEAP. Apart from some of the air pollution programs, where EU standards and NEAP priorities are not fully in harmony, most of the other areas do not present stark choices in this regard.

## **9. FOOD AND AGRICULTURE POLICY IN EUROPEAN PERSPECTIVE<sup>184</sup>**

9.1 With the signing of the Stabilization and Association Agreement with the EU, Croatia faces the imperative to reorient its institutional and policy framework toward the need to compete on European markets. A whole cohort of reforms will be needed to create an internationally competitive agricultural sector and ultimately reconcile Croatia's agricultural policy with the CAP. An analysis of the impact of alternative agriculture policies for agriculture could help the Government in facing the challenge of choosing the right path to approach the future CAP. This study highlights the critical strategy and policy issues for Croatia's food and agriculture sector, providing a set of priorities for agriculture and rural development policies, in the context of Croatia's eventual integration with the EU.

9.2 The chapter will provide an overview of agriculture and food policies and describe the status of sectoral reforms. It will then assess selected impacts of potentially introducing the CAP under alternative scenarios and identify critical issues in this Report. The chapter concludes with reform proposals to accelerate reforms in agroprocessing, input supply and marketing and to adopt EU-type institutions and regulatory system.

### **A. AGRICULTURE AND FOOD SECTORS - OVERVIEW**

9.3 Agriculture, although smaller, continues to constitute an important component of the Croatian economy, and contributed 8.3 percent of GDP in 2001, which is still above the CEECs average. The importance of agriculture in GDP increased substantially in the initial post-independence period, from 10.3 percent in 1990 to 14.9 percent in 1992, mainly due to its higher resilience as compared to the other sectors of the economy which could not sustain the impact of the war and the loss of external markets (Figure 9.1). Since then, however, the share of agriculture has declined significantly, and has hovered around 9 percent since 1995.

9.4 Besides its role in the national economy, agriculture has always played an important role in Croatian society. Of the total population of 4.5 million people, approximately 42 percent live in rural areas. Levels of employment in agriculture, though decreasing, are still relatively high compared to the EU and the most advanced CEECs. After the relative increase at the beginning of the 1990s, when agriculture served as a buffer for livelihood and the sharp loss of employment in other sectors, employment in

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<sup>184</sup> This chapter was prepared by Csaba Csaki and Antonio Nucifora, based on a broader World Bank study by Csaba Csaki, Antonio Nucifora, Rapeepun Jaisaard, Thomas Herzfeld, Stejpan Tanic on the Croatian food and agriculture sector.

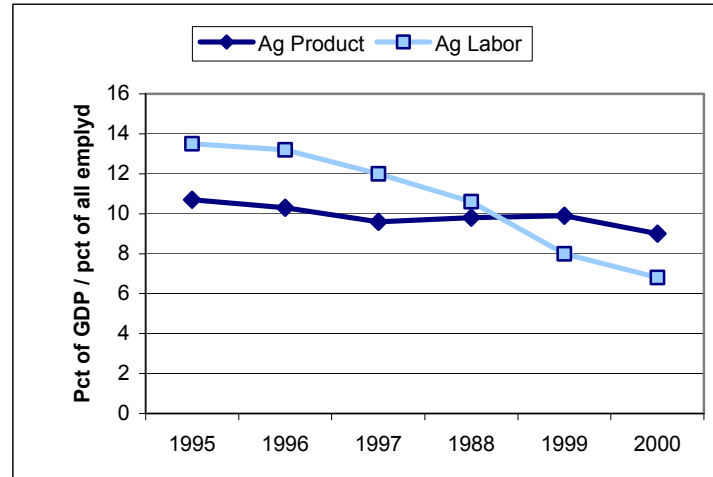
agriculture has decreased to the level of 8 percent. Three-quarters of actively employed in agriculture are self-employed farmers<sup>185</sup> (Figure 9.1).

9.5 Although it decreased less than the other sectors of the economy, agricultural production fell heavily from 1991 to 1992 (Figure 9.2). After the initial collapse in the early 1990s, gross agricultural output started to recover, however, still exhibiting a high degree of variation and instability. Crop production recovered rapidly, driven by a steady increase in the area cultivated, and by 1998 it exceeded its 1990 levels. Livestock production continued to decline from 1992 to 1996, due to a continued reduction of livestock numbers, and has now stabilized at around 70 percent of its original level (Figure 9.2). These differing trends have changed the structure of agriculture production, with crop output increasing to 57 percent of total production in 2001 from 49 percent in 1990.

9.6 Yield trends vary by crop and farming sectors. Maize is the only crop for

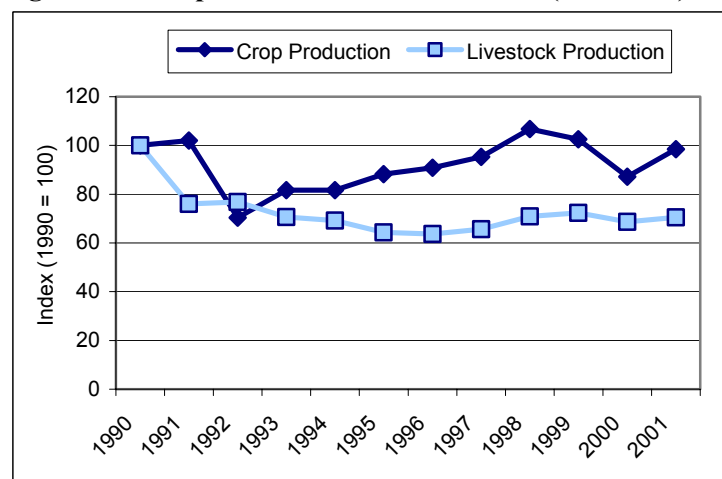
which yields have increased beyond the levels achieved in 1990, and this applies to both private farmers and AKs. For other crops, yields have recovered somewhat since 1992 but remain around or below the yields obtained at independence. AKs yields remain higher than private farm yields, although the margin has narrowed somewhat. In most cases, Croatian yields are below those observed in the EU 15 although close to the average of CEECs. The livestock sector has experienced significant changes in the level

**Figure 9.1: Contribution of Agriculture to GDP and Employment**



Source: Central Bureau of Statistics.

**Figure 9.2: Crop and Livestock Production (1990=100)**



Source: Central Bureau of Statistics.

<sup>185</sup> There are no official employment records and the assessment is based on indirect information about farmer's included in the health and social security schemes.

and composition of production over the last decade. Still, today livestock herds are significantly smaller than in 1990, notably because the cattle herd that is about half its pre-war size. Sheep, pig and poultry numbers have all begun to increase since 1998, due perhaps to increased demand in response to higher disposable incomes. As with crop production, per animal production is generally well below EU standards. In addition, livestock yields are significantly below those achieved by the EU accession countries.

9.7 The economic crisis of the early 1990s badly affected the food industry. Following independence and war, the socially-owned agroprocessors lost their traditional markets in former Yugoslavia. Their resultant over-capacity was exacerbated by the fall in domestic agricultural production and domestic demand. Output fell by over 35 percent, and since 1993 it has remained at less than 65 percent of 1990 production levels. Correspondingly, the share of agroprocessing in GDP decreased from 6.9 percent in 1990 to 4.6 percent in 2000.

9.8 Trade in food and agricultural products account for about 10 percent of all exports and 9 percent of all imports in 1999-2001, with trade in processed food products accounting for 70 to 80 percent of the total. This is somewhat lower than in the early 1990s, when agriculture accounted for about 14 percent of exports and 13 percent of imports. The agricultural trade deficit was almost US\$400 million in the year 2001.

9.9 Croatia's traditional trading partners in the former Yugoslavia are the most important market outlets, accounting for 55 percent of all agricultural exports in 1999 and 2000. In 1999 and 2000, the EU accounted for 42 percent of imports. A strong negative balance of trade thus characterizes trading relations with the EU, in contrast to the positive balance of trade with the countries of the former Yugoslavia. The volume of trade with the EU, both exports and imports, is likely to increase significantly in the future, as a result of the SAA which has reduced the barriers to trade on both sides of the border.

## **B. STATUS OF SECTORAL REFORMS - ISSUES**

9.10 As a result of overall macro-economic reforms, the agricultural sector now operates in a macro-economic and trade environment with direct links to world markets. The level of policy and institutional reforms achieved by Croatian agriculture, is, however, lower than among the leading reformers within the EU accession and candidate countries. According to the World Bank agricultural policy rating system evaluation<sup>186</sup> (based on a 1-10 scoring system where 1 represents a centrally planned economy and 10 represents a fully developed market economy), Croatia achieved a score of 7 in 2001, up from 5.8 in 1997. This constitutes significant progress in recent years, but Croatia is still behind Poland, Lithuania, and Romania, and still further behind the front runner countries of the Czech Republic, Hungary, and Slovenia. Current support programs, however, represent a complicated and sometimes inconsistent package which obviously creates

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<sup>186</sup> For a discussion of the methodology involved in this ranking system, refer to C. Csaki and J. Nash, *The Agrarian Economies of Central and Eastern Europe and the Commonwealth of Independent States: Situation and Perspectives 1997*, World Bank Discussion Paper No. 384, World Bank 1998.

distortions. The Ministry of Agriculture describes the current agricultural policy framework as gradually evolving toward CAP-type instruments. In reality, however, they would need further adjustment to fully conform with current EU practices. Past government interventions were largely discretionary and frequently lacking in transparency, as opposed to the rule-based systems of public intervention that characterize well-managed market economies. Without a more credible and consistent approach to policy and implementation, producers and processors will continue to avoid or postpone the changes that are needed to improve the sector's overall competitiveness.

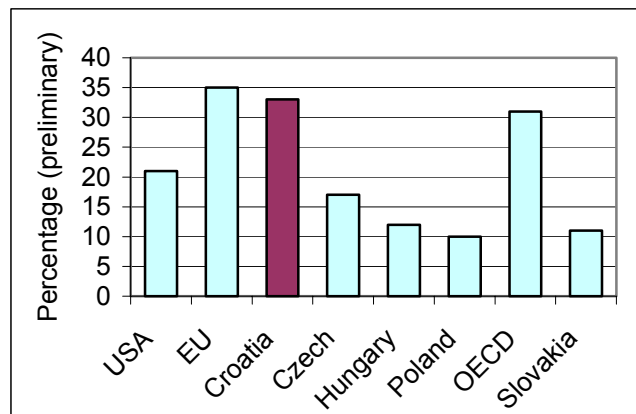
### Distortive Agricultural Support Policies with High Subsidization

9.11 The current system of price and support policy has its roots in the reforms introduced in 1998, in conjunction with the reform of trade policy required for WTO membership. To compensate farmers for the reduction of import protection and associated floor (producer) prices, area payments were introduced for most major crops combined with a quota system. Direct price subsidies for crops and all input subsidies were terminated.<sup>187</sup> These reforms have led to a significant increase in budget expenditures (from 2 percent of the central budget in 1995-1998 to 4.4 percent in 2000) supporting agriculture. On average, in the period 1999-2001, 54 percent of the agriculture budget was spent on support to crop production and 33 percent was spent on livestock production.

9.12 Reflecting this high level of Government expenditure, the percentage Producer Support Estimate (PSE) for Croatian agriculture appears to be quite high.<sup>188</sup> This basic measure of agricultural support was estimated at 33 percent in 2001. The current level of support, while comparable to EU and OECD averages, is significantly higher than that provided by its neighboring CEECs (Figure 9.3).

9.13 The Government hoped that the increased support would reduce production costs and by extension, farm gate prices, and at the same

**Figure 9.3: Producer Support Estimates (percentage) for Selected Countries in 2001**



Source: OECD and staff calculations.

<sup>187</sup> Implicit input subsidies remain on fuel through tax exemptions, and on interest rates for publicly funded rural credit programs.

<sup>188</sup> The Producer Support Estimate is an aggregate measure of support that summarizes the effects of a variety of government policy measures in a single figure (OECD 2000, 1987). In brief, to compute the PSE for a given year one has to calculate the ratio of total transfers to producers by the value of production adjusted for direct payments and levies to producers.

time secure adequate income levels for farmers. In reality, however, the area payments were combined with the requirement to purchase the inputs from domestic producers and traders, who, protected by tariffs, exhibited monopolistic behavior. This resulted in transfer of benefits to upstream and downstream sectors. Moreover, the allocation of (subsidized) area quotas was left to the local municipalities. This introduced an arbitrary decision process, supposedly carried out on the basis of the previous production structure, but often in a non-transparent manner. The system of subsidies was based on an arbitrary annual allocation which could give rise to lobbying and bad governance. The allocation of subsidized area quotas has had the effect of freezing and perpetuating the existing production pattern. Moreover, it has negative distribution effects; the small farmers who mainly produce for home consumption are excluded and the largest farms, as well as monopolistic processors and traders get most of the benefits.

9.14 A new reform of agricultural support policies was approved in 2002 and became effective in 2003.<sup>189</sup> This reform brings in a number of significant changes that addresses several weaknesses of the previous system. The main innovative feature is that *any farm can now apply and automatically receive the production payments, without having to be allocated a quota by the municipal authorities. Introduction of a national maximum supported quantity of each particular production* has been envisaged to make sure that total expenditures do not grow unchecked. If the requests exceed the total national quantity (crop area or livestock heads) the specific incentive will decrease proportionally. *Also a maximum amount of yearly subsidy payment per farm has been introduced.* Other important features of the new approach are the separation of economic and social objectives—that are mixed in the current system—and the separation of sectoral and rural development support policies. A basic precondition for introduction of this new system is the classification of rural households between commercial or potentially commercial, and economically viable farms, and non-commercial households on the basis of the size measured in production units and the age of the active household family members. Since this implies creation of the farm register, which has only just begun (and is partially constrained by unresolved problems with the land register), the new system is likely to experience some difficulties initially.

9.15 Under the new reform, policy instruments are grouped in four categories:

- A “production support scheme” is envisaged for commercial farms, which have the obligation to register in the farm registry and to pay VAT. The production support program is similar to the existing model and consists of annual area payments for most arable and permanent crops and annual payments per livestock head. However, the number of different support schemes will be reduced (from 12 to 9 groups), allowing for larger product groupings eligible for area payments. This has the advantage of allowing farmers slightly greater flexibility to allocate quota areas across more products (within each group). As mentioned above, any farm can now

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<sup>189</sup> The new ‘Law on State Subsidies in Agriculture, Fishery, and Forestry’ was approved in July 2002 and became effective in January 2003.

apply and receive production payments, and the level of subsidy may vary depending on total requests.

- In addition, commercial farms also benefit from the farm capital investment scheme, which envisages the institution of grants for farm investment – up to 25 percent of total investment. No further details of this scheme have been made public so far.
- A new “income support scheme” is an alternative to the production scheme and has been envisaged for non-commercial farmers who are at least 55 years or older (mainly family farms with limited production). Qualifying farmers are now offered the option to receive an annual lump-sum income support payment in place of area production subsidies. This is aimed at stimulating the exit of small farms with elderly household members and creating an enabling environment for land market transactions leading to an increase in average farm size.
- A “rural development scheme” is envisaged as competitive grants in support of the projects within three major support programs (a) development of rural areas; (b) protection and preservation of authentic animal breeds; and (c) marketing of local produce.

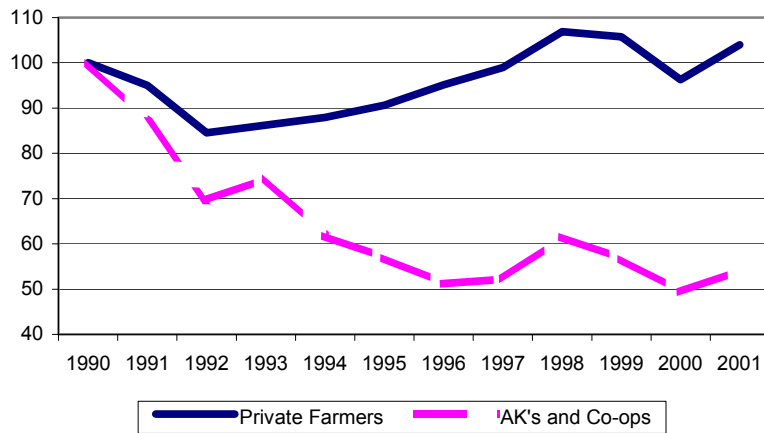
### **Incomplete Transition in the Farming Sector**

9.16 Croatia was one of the few countries in Central and Eastern Europe whose agriculture was not collectivized and remained predominantly organized in private family farms. Small-scale farmers with less than five hectares of land owned three-quarters of arable land, while the remaining quarter belonged to large AKs that frequently combined production and processing activities. Croatian traditional farm managers at the AKs seem to have been in a better position than in most other Central East European countries to apply survival strategies based on payment arrears, soft state budgets, and bad debts; they also seem to have enjoyed more effective political representation and support which ultimately delayed rather than facilitated their restructuring. This bi-modal farm structure has continued to prevail with profound implications for the development of the sector.

9.17 The public and private responses to economic transition have indeed differed substantially (Figure 9.4). Small-scale private farms recovered quickly from the impact of war and have increased output steadily since 1992.<sup>190</sup> By 1998, their production exceeded the level achieved in 1990. The AKs and cooperatives, on the other hand, have struggled to respond to the new economic environment. Output fell steadily after 1990 until it stabilized at 50 percent-60 percent of independence levels in 1996 and 1997. Livestock and crop output fell in equal measure during this period, reflecting the inability of these enterprises to adapt to the constraints and opportunities created by reform. Private family farms produce the bulk of agricultural output.

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<sup>190</sup> Measured as an index of net agricultural production (excluding crops used for animal production), valued at a three-year moving average of producer prices; as reported by the Croatian Bureau of Statistics.

**Figure 9.4: Agricultural Production Indices (1990=100)**

Source: Croatian Central Bureau of Statistics.

### Unconsolidated Land Ownership with Significant Role of the State

9.18 Although private land ownership continued to exist during communist rule, it was constantly restricted. Currently, 30 percent of the agricultural area remains under state ownership. The transfer of state agricultural land ownership is proceeding very slowly; only a negligible 7,280 hectares of state-owned land has been sold so far. Documentation on private land ownership remains sketchy. For more than half a century, land transactions between private owners were not properly recorded in the cadastre and land books. For roughly 40 percent of the agricultural land area, the ownership remains unclear and according to government estimates, it will take up to 15 years to clarify all private land ownership disputes. Currently, there are about 300,000 unresolved land registry cases at the various land courts. As a result, land markets are barely functioning.

9.19 There is, however, an active informal lease market, especially among private farmers, and mainly for short-term leases, and this market provides some (limited) flexibility at present. Land leasing has, to some extent, always been a practice between private individual farmers even during the socialist period. Land leases were based on informal agreements for short terms leases, most often annual, while rents were determined in kind. Although there are no official records of the extent, this practice has continued during the last 10 years. However, there was also an increase in formal leasing arrangements, particularly by pro-active and more commercially oriented farmers. Furthermore, the introduction of direct payment systems also stimulated formal leasing arrangements, because when applying for subsidies, farmers may also use lease contracts as proof of land availability. Realizing that the lessees benefit from state support (area payments may account for almost 30 percent of the gross income per hectare), lessors tend to increase rents.

9.20 The Government has a decisive role in land markets. First, its influence on land policies and second, as the largest single landowner in the country. Buyers of state-owned land currently have access to highly subsidized state credit, which inflates land prices. There is no justification for taxpayers subsidizing the purchase of land. Non-collection of

lease payments has a similar result. The less efficient farms are thus able to survive, and land does not become available to the potentially more efficient.

### **Barely Restructured Agroprocessing Industry**

9.21 Due to the slow pace of privatization and the low levels of FDI, only limited restructuring and modernization has occurred in Croatian agroprocessing over the past decade, resulting in a continued decline in the output of most commodities. The agroprocessing sector can be broadly differentiated in three groups:

- Private sector processors are mostly modern and up to international standards. Several have constructed new state-of-the-art facilities and are manufacturing and trading against top line competition from neighboring countries and multinationals, and are supplying into the supermarket chains. They are progressing well and some appear set to become important players on a regional basis.
- The second group is composed of privatized former public sector companies—food processors—that have been bought out, usually by the employees or managers, and have commenced major modernization programs with substantial investments. Many companies are operating successfully and are exporting.
- The worst situation is being faced by the third group, the AKs. Many of these are loss-making, still public-sector enterprises that have been bailed out with Government funds several times and are in a holding pattern pending decisions on privatization. The plants and buildings at most AKs processing factories are reportedly in poor condition and deteriorating. These firms will face renewed pressure over the next 3-4 years, as trade protection declines due to the reductions negotiated with the WTO.

### **Weak Commodity Markets**

9.22 The poor development of competitive agricultural markets at the wholesale level would create quite a significant impediment to introducing the CAP. One of the main characteristics of the CAP is the fact that price and market support is mostly done at the wholesale level and not at the farm gate. It constitutes an indirect support to farmers and not a direct intervention by buying directly from farmers. As a result, farmers in the EU benefit most when wholesale markets are competitive and the commercial margins taken by the wholesale marketing agents remain minimal, thanks to a high degree of competition. If, as is often the case in Croatia, a small number—sometimes only one—buyer is active in a region, there is not much pressure on this buyer to minimize its commercial margin nor its costs. The rent created by the intervention of the State (in the form of market price support) in such a case is likely to remain in the books of the local monopoly rather than being passed on to its suppliers. The competitive functioning of wholesale markets, therefore, is an essential prerequisite to the transmission of the CAP-like support to producers. The current status of wholesale agricultural markets in Croatia raises the possibility that these gains will accrue to the oligopolistic wholesale agents

rather than the farmers. Accordingly, the Government should facilitate the emergence of alternative and competitive private wholesaling firms for major agricultural products. Marketing cooperatives and associations have yet to establish a strong presence in agricultural markets, as the basis for improved market access and lower marketing costs.

### **Limited Use of Credit**

9.23 A strong private sector capacity for lending to small, private farmers has yet to evolve in Croatia, and public lending to these farmers is very limited. Available data suggest that less than 1 percent of the total number of small farmers is currently borrowing 80-90 million kuna annually, with an average loan size of 40,000-45,000 kuna. Public schemes, such as the Ministry of Agriculture Special Account for the Development of Agriculture (SADA), and the Croatian Bank for Reconstruction and Development (HBOR) rural SME program, have had mixed results at best, the former due to the high default rates and the latter due to the very limited amount lent to small farmers (about 12 million kuna). On the private side, the limited involvement of commercial banks in farm lending is caused by a lack of expertise in dealing with small farmers, the low level of profitability and potentially high-riskiness of farming, the relatively high transaction costs of the small loans required by small-scale farming, the existence of government credit schemes with subsidized interest rates which undermine the commercial market, the lack of provable title to land (and the lack of adequate land markets which limit the collateral a farmer can provide), the weak enforcement of contracts and bankruptcy procedures, and a culture of non-repayment of loans.

9.24 There has been little effort to broaden the institutional base for credit delivery beyond public credit programs and traditional commercial banks. Other than some small savings and credit cooperatives, the private sector financial institutions that target small enterprises and flourish in rural areas elsewhere are absent in Croatia. Given the large population of rural households, most of whom are part-time farmers, there is no obvious reason that the savings and credit cooperatives could not be expanded, and that micro-credit organizations could not be established. There is equal scope for specialized commercial banks such as the Micro-Enterprise Banks now operating successfully in Serbia, Bosnia and Kosovo, which also target small enterprises.

### **Weak Representation of the Private Sector**

9.25 The Agriculture, Forestry, and Food Industry Department of the Croatia Chamber of Economy (CCE) presently acts as the overall representation of the various players in the food and agricultural sector. All legal commercial entities in Croatia are required to register with the Chamber. Although the CCE purports to represent private farmer interest, however, it represents primarily the interests of larger corporations, which in agriculture tend to be the remnants of former socially owned enterprises. The CCE does not seem to provide an adequate representation of private interests for each profession in terms of vertical integration of each particular subsector. Adequate representation of all stakeholders or agents is crucial for the smooth operation of markets, as it ensures that all interests are accounted for in the decision making process and that market power is well balanced across all agents. Asymmetric distribution of market power is at the root of

market failures associated with oligopolistic rents. Similarly, a lack of adequate representation will eventually lead to sub-optimal policy decisions. In the EU, such representation is a crucial element of the implementation of the CAP. It contributes to a better understanding of private interests by the European Commission and the governments in the EU, and of government policies by the concerned private sector. In addition, many decisions related to trade, research and technology, market information, training could be taken in common by operators belonging to the same profession or to the same marketing chain (the so-called inter-professional associations, or, like in Hungary, the "product councils"). The development of such organizations should be promoted and facilitated, parallel with the abolishment of compulsory membership in the CCE.

### C. FUTURE POLICY OUTLOOK AND WELFARE IMPACT

9.26 Croatia is likely to experience a number of changes in agricultural policies over the next few years. *First*, a reform of agricultural policies has just been introduced in January 2003. *Second*, the implementation of the SAA will lead to a free trade area between Croatia and the EU. *Third*, Croatia may eventually join the EU's Common Agricultural Policy.

9.27 The implications of the adoption of the various agricultural policy scenarios on farmers incomes, on consumer incomes, on poverty levels and on the budgetary implications has been simulated using a partial equilibrium modeling framework. The key results of the model's simulations for each of these policy changes are summarized below.

#### Impacts of the 2003 Reform of Agricultural Policies

9.28 As discussed above, the 2003 reform will bring in a number of significant changes. The reduction in the number of product groupings in the support schemes will allow greater flexibility to producers in production decisions. As a result, the levels of support for some products will be changed, leading to adjustments in production. The impact will not be homogeneously distributed, with some farmers gaining and some losing, depending on their production mix. The net result should be an overall increase in farmers' income. This will be achieved via an increase in budgetary outlays financed by taxpayers. *Our simulations indicate that the 2003 reform of agricultural policies will altogether increase farmers' incomes by 8 percent, but lead to a 0.24 percent reduction of average household incomes due to higher taxes needed to finance the new farm support expenditures.*

#### Implementation of the SAA

9.29 The implementation of the SAA will eventually lead to a free trade area between Croatia and the EU. All quantitative import restrictions have been abolished with the entry into force of the Agreement. Also, the Community has abolished all customs duties and charges on imports of agricultural products originating in Croatia (with very few

exceptions).<sup>191</sup> Croatia has abolished custom duties for some products and will progressively reduce duties on the remaining products to between 20 percent to 50 percent of current levels (depending on the product) by 2006. A scenario was run to simulate the effects of implementation of the SAA under the current 2003 reform regime. Elimination of restrictions and reductions in duties on agricultural goods will generally lead to a decrease in agricultural prices (although the price of a few products will moderately increase), leading to an overall average 4 percent decrease in food prices favoring consumers in general and the poor in particular – in view of the larger share of food on their consumption basket. *Overall, the implementation of the SAA will lead to lower prices which in turn will imply real income gains of 1.5 percent on average household income and will reduce poverty by about 1.7 percent. The continuation of the current regime of direct payments in Croatia will lead to a projected 2.5 percent increase in farmers' incomes - agricultural production will rise 6 percent on average – over the long term.*

### **Adoption of the Common Agricultural Policy**

9.30 What would then be the additional impact of adopting the EU's CAP? EU-like agricultural reforms would probably have a mixed impact on incomes in Croatia. While the new policies would harm farmers, the population as a whole would be better off due to lower food prices on average- some agricultural prices will rise and others will fall. Specifically, compared to current policies (as envisaged under the 2003 reform), the CAP-type policies would lead to *a reduction in farmers' income of about 1.6 to 1.9 billion HRK, and an overall gain for consumers of about 2.6 to 3.6 billion HRK. These calculations imply a net welfare gain of between about 0.6 percent to 0.8 percent of GDP as a result of the reduction in agricultural support (compared to existing policies). Further, under the CAP-like policies, the number of poor people in Croatia is projected to decrease from 28.7 percent to 27 percent.*

9.31 The magnitude of negative impact of the CAP on farmers' income compared to the 2003 reform policies depends on the amount of direct payments and the level of support prices. The highest decrease in farmers' income would result from the simulation of the so-called "Agenda 2000" policies, without direct payments: these would lead to a reduction of farmers' incomes of about 35 percent in the medium to long term. However, implementation of Agenda 2000 policies including EU direct payments (at the level of 35 percent of those granted to EU farmers, in line with the recent EU proposal to accession candidates), would limit the reduction in farmers' income to 24 percent (compared to the base scenario).

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<sup>191</sup> EU agricultural products also benefit from production subsidies and export subsidies. These subsidies, however, are within the limits allowed under existing WTO agreements. In order to counteract this problem, several accession countries have negotiated the so-called "double zero" trade agreements with the EU. These agreements open up farm trade in a smooth, step-by-step way, through developing trade flows on which neither duties nor export refunds are paid. This type of negotiated agreement would allow Croatia to resolve the issue in a manner that does not violate its WTO commitments.

### **The Net Welfare Impact of Various Agricultural Policy Scenarios Against the Counterfactual of No Intervention**

9.32 A scenario has also been run to evaluate the impact of the various agricultural policies discussed above by comparing the impact of the various policy regimes with the results of the *removal of all government policy interventions (and assuming no EU transfers)* (Scenario E in Table 9.1). The results of this comparison in the model's simulation highlight that significant economic welfare losses were associated with pre-2003 agricultural policies. In fact, *as much as 2.7 percent of Croatia's GDP was being lost (change in net welfare) as a result of pre-2003 government intervention in agriculture* (Scenario A.1 in Table 9.1). Pre-2003 intervention had a positive impact on farm incomes, but a more than equivalent negative impact on the income of the population at large, due to the higher food prices associated with these policies.

9.33 Simulations show that agricultural policies under the 2003 reform (Scenario A/2 in Table 9.1) result in an even larger (77 percent) increase in average farm incomes compared to a non-intervention scenario. However, as in the previous scenario, higher food prices imply increases in consumers' food expenditures of about 10 percent on average and, since Croatian households on average spend about one-third of their disposable income on food and beverages, an equivalent 3 percent reduction in average household incomes, with the greatest reduction for the poorest households. The net welfare loss – 2.7 percent of GDP – vis-à-vis the non-intervention scenario is similar to the pre-2003 policies since the increase in farmers' income (HKR637.5 million) is far smaller than the reduction of household incomes (HKR5248 million). Given the large impact on farm incomes, these results also call for caution in removing government intervention in agriculture. However, they also suggest that it would be more efficient to transfer income to farmers directly via equivalent lump-sum payments, without distorting agricultural markets and creating such large welfare losses.

9.34 Although the adoption of CAP policies (Scenarios C2 and C3 in Table 9.1) would represent a welfare improvement with respect to the pre-2003 regime, these policies still would fall short of achieving the economic gains associated with a system based on lump-sum payments and no distortions. When measured against the standpoint of economic efficiency, it becomes clear that adoption of the CAP would maintain significant economic welfare losses in Croatia's agricultural sector. Specifically, simulations show that the CAP Agenda 2000 policies would correspond to net welfare losses of about 1.3 percent GDP compared to the removal of government intervention scenario. Compared to a non-intervention scenario, the CAP Agenda 2000 policies would lead to increases in farmers' income of about 0.5 billion HRK (excluding direct payments), but an overall loss for consumers of about 2.6 billion HRK, again due to the higher food prices. As mentioned, the net welfare losses are somewhat smaller than under the current policies, at about HKR2.2 billion (or 1.3 percent of GDP). These policies, therefore, represent a moderate improvement with respect to pre-2003 agricultural policies in Croatia, and fall short of the gains that would originate from the complete removal of distortions (2.7 percent of GDP).

9.35 Simulations show that the CAP mid-term review proposals (scenarios D1 and D2 in Table 9.1) also would fall short of achieving the full welfare gains which would arise from removal of government intervention, but they would constitute an improvement with respect to current policies and CAP Agenda 2000 policies (as a result of the slight price reductions envisaged in the CAP mid-term reforms). As compared to a non-intervention scenario, the mid-term review would lead to an increase of about HRK0.07 billion in farmers' income and an overall loss of about HRK1.6 billion for consumers. The net welfare loss compared to a non-intervention scenario would be just under 1 percent of GDP. Both the Agenda 2000 and mid-term review scenarios are associated with increases in the percentage of the population below the broad poverty baseline poverty (respectively an increase of 1.5 percent and 1 percent) albeit less than under current Croatian policies.

**Table 9.1: Net Welfare Impact of the Various Agricultural Policy Scenarios, Compared to Non-Intervention**

	Change in farmers' income <sup>1</sup> (long-term)		Direct payments	Change in farmers' income less direct payments (Long-term)		Change in household income (long-term)		Change in net welfare (long-term)		Poverty (long-term)
	(1) Million HRK	%	(2) Million HRK	(3)=(1)-(2) Million HRK	%	(4) Million HRK	% <sup>2</sup>	(5)=(3)-(4) Million HRK	(5)/GDP)*100 Percentage of GDP	Percentage of population below Broad Baseline <sup>3</sup>
Scenario E: Non Intervention	0	0.00	0.0	0.0	0.00	0.0	0.00	0.00	0.00	25.9
Scenario A1: Pre-2003 policies	2114.3	67.91	1514.6	599.7	19.26	-5248.9	-3.04	-4649.2	-2.69	28.7
Scenario A2: 2003 reform policies	2397.9	77.02	1760.4	637.5	20.48	-5248.9	-3.04	-4611.3	-2.67	28.7
Scenario C2: Agenda 2000 with 35% direct payments <sup>4</sup>	1107.6	35.58	607.6	500.1	16.06	-2659.0	-1.54	-2158.9	-1.25	27.4
Scenario C3: Agenda 2000 without direct payments <sup>4</sup>	457.5	14.69	0.0	457.5	14.69	-2659.0	-1.54	-2201.5	-1.28	27.4
Scenario D1: Mid-term review with 35% direct payments <sup>4</sup>	841.4	27.02	775.1	66.3	2.13	-1674.8	-0.97	-1608.5	-0.93	26.9
Scenario D2: Mid-term review with decoupling <sup>4</sup>	840.6	27.00	775.1	65.6	2.11	-1674.8	-0.97	-1609.3	-0.93	26.9

Notes:

1. Income effects deriving from market price support and income effects deriving from direct (compensation) payments to farmers are considered jointly.

2. Based on HR GDP of HRK billion 172.66 in 2001.

3. Poverty Line using Food-Energy-Intake method + 50%. The base data for Scenario A were taken from *Poverty and Inequality in Croatia*, Erzo Luttmer (2001), Background Paper for *Croatia: Economic Vulnerability and Welfare Study* (World Bank Economic Report 22079).

4. These are the direct payments granted to EU farmers as compensation for the price cuts introduced under the CAP reforms in 1992 and 1999.

Source: World Bank staff estimates.

## D. CRITICAL ISSUES FOR EUROPEAN INTEGRATION

### Selecting the Appropriate Course for Agricultural Policy

9.36 The logical conclusion of the simulations presented above is that Croatia would be better off (a) to align its instruments of agricultural policy with those of the CAP; and (b) to bring down the levels of produce support from the current high levels to below those currently offered within the EU. The levels of support within the CAP are in any case declining and Croatia must take into account the evolving reflect, among others, the results of the 2002 WTO Ministerial Conference in Doha. In the interim period, Croatia would be best served by a set of agricultural policies that significantly reduce or eliminate current distortions to achieve potential welfare improvements elaborated above. Croatia should also facilitate the process of privatization and restructuring to ensure improvements in efficiency and competition. A two-phase strategy is therefore recommended (a) immediately remove current distortionary policies and implement policies to accelerate farm restructuring; and (b) prepare for the adoption of EU agricultural policies, but not apply them (or not apply them at the same level as the EU) until accession. nature of the instruments and requirements of the CAP as a “moving target”. The latter will need to be adjusted to

9.37 In the first phase, current policies should be immediately reformed to concentrate support towards enhancing efficiency and competitiveness, as well as reducing the overall levels of support, in order to create the necessary pressure for the required restructuring in primary production and processing. The agricultural policy framework and support system would need to focus on the following objectives:

- **Removing the current policy emphasis on self-sufficiency (expressed in a range of price support measures and direct production incentives).** The new support program continues to use the argument of food security to advocate self-sufficiency of food production. Given the open trade environment of our time in general, and the trade goals of European integration in particular, Croatia should shift its agricultural policy away from self-sufficiency and towards competitiveness and efficiency in agricultural production.
- **Refocusing agricultural policies towards improving competitiveness and accelerating farm restructuring.** A more effective use of budgetary support to agriculture requires the revision of support programs to focus on efficiency enhancement rather than direct subsidies. In order to support efficiency enhancement, many EU accession countries have made investment grants the major form of budgetary support to agriculture. Other policies to facilitate efficiency enhancement include measures facilitating the exit of inefficient farms via the imposition of hard-budget constraints and good bankruptcy legislation and procedures, and removing obstacles to the expansion of new and more efficient units such as the unresolved land ownership issues and the creation of functioning land markets.

- **Strengthen the separation of social safety-net from agricultural policies.** Measures to reduce social tensions and provide social protection in the rural areas need to be separated from the major instruments of agricultural policy aimed at improving efficiency and competitiveness. The 2003 reform of agricultural policies has made progress in the right direction.

9.38 The second part of the strategy, therefore, entails the **adoption of the same policy instruments as used in the EU** (but not applying them at the same level as in the EU). Agenda 2000 and other recent proposals for the reform of the EU's CAP should be used as a benchmark in this work. In particular, the following adjustment would need to be considered:

- The market support system needs to be adjusted to a transparent CAP-conforming framework incorporating the potential use of quotas in the case of some products. Changes should be made in the current intervention which is based on an *ex-ante* system (the intervention is based on short-term forecasts on production and consumption) to an *ex-post* CAP type intervention mechanism when market intervention decisions by private sector are based on the observed evolution of market prices. In addition, to be consistent with the principles of the CAP, price support would need to be transferred to the wholesale level instead of the farm gate for most products.
- The direct payments and other current structural support measures have to be adapted to the EU format, while new ones, such as an agro-environmental program will have to be introduced. The generalized area payment scheme outside of the less-favored areas could be adapted and fitted into the national envelopes proposed for the dairy and beef sectors under the Agenda 2000.
- A more integrated regional and rural policy and related support programs have to be developed.
- The taxation system and the provided tax concessions need to be harmonized with the EU practices and requirements. All tax preferences for farmers, in particular, would have to be eliminated (including the current tax exemptions on fuel used for farming purposes).

### **Consolidation of the Farming Sector**

9.39 The task of creating a farming sector that has the potential to be competitive in an eventual European environment is complex. Policy and institutional measures should concentrate on the following major objectives.

- **Settle remaining land ownership issues and create conditions for a functioning land market.** A strict deadline should be set for identification and resolution of uncertain land ownership, and beyond that deadline much of the state-owned land should be expeditiously privatized through

auctions. It is also essential to remove distortions and uncertainties resulting from the involvement of local authorities from the land lease markets. Specifically, the following actions can be recommended: resolve all outstanding claims for land restitution with a strict deadline in the near future;

- accelerate the development of a land cadastre and registration system to facilitate both restitution and settlement of all existing registration problems;
  - break up most of the unclaimed state-owned farmland into lots and sell by tender as a means of enlarging or creating viable private farms;
  - terminate the subsidized loans currently given for purchases of state-owned land;
  - strictly enforce all existing lease and land concession contracts; and
  - drop the legal provision to renegotiate land lease prices.
- **Accelerate the privatization and restructuring of remaining AKs and other large farming structures.** The Government should revise its current approach to privatization of agro-combines, since in their current form they do not provide a viable framework for profitable operation. Several recommendations can be made:
    - First, the privatization of the remaining AKs should take place immediately to avoid any further waste of public funds and any further deterioration of the conditions of the equipment and buildings at most AKs processing factories.
    - Second, privatization should be carried out on the basis of individual components, which would be formed as separate legal entities prior to privatization. The Government should not attempt to keep the AKs intact. Its role should be limited to dividing up the AKs according to existing functions and offering each part for sale separately, without any attempt at ‘second guessing’ what commercial investors actually want. Those units that do not find viable commercial investors within a given time period should be liquidated.
    - Third, the Government must recognize that as indicated by the experience of other transition countries and past experience in Croatia as well, privatization of financially insolvent companies does not lead to the desired results. These companies require new capital, market linkages, new products, etc, that an employee/general manager group is not able to provide. Therefore, privatization should aim at attracting new owners, either domestic or foreign, and additional FDI.
  - **Impose hard-budget constraints.** Unprofitable farms must be allowed to disappear and free the resources for profitable and efficient operations. This can only be achieved by adopting hard-budget constraints, encouraging strict financial discipline, and effectively implementing the ultimate threat of bankruptcy for non-performers, regardless of farm type.

## **E. ACCELERATING THE NECESSARY REFORMS IN AGROPROCESSING, INPUT SUPPLY AND MARKETING**

9.40 The main impediments to Croatia developing competitive processors, marketers and the farms behind them concern land, post-harvest services, finance, irrigation and transport, investment conditions, regulatory burden, company governance and management. Certain technological supports are also crucial. The overall strategy should be to help all elements to become entrepreneurial and dynamic by reducing impediments and ensuring the availability of technological supports (Box 9.1). The continuing impediments in Croatia to efficient business operation, such as time-consuming registration requirements, difficult logistics, red tape, corruption, unreliable contract enforcement, legal vulnerability, non-transparent taxation, standards and regulations that are inconsistent with EU standards, etc. also need to be addressed.

### **Box 9.1: Challenges for the Agroprocessing Industry**

Processors in all transition countries, including Croatia, will be acutely affected by new EU legislation requiring all meat, milk and processed food products to be from HACCP-registered processing plants by January 1, 2004. This new deadline leaves the Croatian industry with considerable and costly work to be done in a very short time to bring their processing plants up to HACCP standards. The less profitable and poorly managed plants will not be able to finance the costs of modern equipment meeting ISO standards.

The primary task of Croatian agriculture and agribusiness must be to improve product quality and packaging while at the same time be able to compete on price, initially in domestic markets. From this base it can then expand into regional and EU export markets. Though export markets offer the potential for growth based on competitiveness, they presently account for a relatively small part of the value of total agricultural output. Products for export must continually meet the cost, quality, product-characteristic, delivery, and reliability requirements of evolving foreign consumer demand. The limited number and value of export commodities and the difficulty of meeting export market requirements, limits the capacity of agricultural exports to pull the whole sector into sustained growth or even to prevent decline.

The Government should not attempt to “pick winners” by favoring particular commodities, industries, work forces, types of enterprise or export destinations, but rather aim to develop an enabling environment for investment and production. Increasingly competitive domestic and international markets will pick the winners (and losers) on a continuous basis. Governmental regulations and “help” typically insulate their intended beneficiaries from the consequences of poor market performance, distort their incentives, prevent the adjustments necessary to retain market share, prevent the transfer of resources to firms and farmers that can adapt, and ultimately, cause the “beneficiaries” to fall far behind. Among other things, the Government should move to improve the climate for investment and SME development (e.g., reduce regulatory burden, improve contract enforcement and tax administration, improve product standards). In particular, it should create the conditions that foreign investors, with their knowledge of international food-industry trends, need to provide finance, technology, and risk-taking, management and marketing skills. One element of this is to improve the legal framework and enforcement to reduce monopolistic practices in agroprocessing and input supply.

9.41 Marketing cooperatives potentially have an important role in high-quality post-harvest activities and some processing and in intermediating between small holder producers and supermarkets and large distributors and exporters. But private, entrepreneurial agroprocessors and packers (and some large farms) will have the leading role in developing competitive high-value agricultural production, but only if there is a conducive business environment for them to operate in and grow. They are best placed to

sell in export markets, and thereby gain the volume necessary for competitiveness and market penetration.

9.42 Other needed reforms are to (a) improve court capacity for contract enforcement, and improve tax administration, which is perceived as non-transparent; (b) protect the rights of farmer cooperative members through the separation of cooperative professional management and membership (the establishment of a one member, one vote rule, the linking of membership fees to contribution to cooperative throughput, and the establishment of the unassailable indivisibility of cooperative assets); (c) develop a real-time national and international market information system, the national data based on production and marketing data provided by growers' associations (the current system is of limited use to agricultural traders and farmers); and (d) improve the efficiency of all private sector agents through programs to improve business management.

#### F. CREATING EU-CONFORMING INSTITUTIONS AND REGULATORY SYSTEM

9.43 The Government of Croatia has already started the process of harmonization with the EU legislative and administrative system and has drawn a list of preparatory actions to begin the harmonization of Croatian legislation with the *aquis communautaire* in the area of agriculture and food. Given the administrative complexity involved in the operation of the CAP, the adjustments required are quite substantial. Not only the alignment of legislation will be necessary, but also the development of the judicial and administrative capacity to implement and enforce the new arrangements. Some institutions will need to be strengthened and some new ones created. Specific points of concern regarding the administration of the Common Agricultural Policy, food safety and control institutions, and veterinary and phytosanitary services, are highlighted below.

- **The establishment of an Agricultural Intervention Agency and a Paying Agency is a necessary prerequisite for the implementation of CAP-like arrangements.** The Agricultural Intervention Agency's main purpose would be to manage the smooth operation of the agricultural support regimes and their transition towards the CAP. The Payment Agency would disburse direct payments and other subsidies to farmers. Croatia is now taking initial steps in establishing a payment agency.
- **The introduction of the Integrated Administration and Control System (IACS) also constitutes a critical prerequisite for the functioning of the CAP.** The introduction of the IACS centralized database is particularly challenging because the current system in Croatia is entirely different from the EU-style IACS, and because the data required for the IACS system are not easily available. Notably, there is currently no farm register, no functioning cadastre and no Geographical Information System (GIS) imagery in Croatia. In addition, as is discussed below, the register of livestock herds is shared between two institutions. The Ministry of Agriculture and Forestry (MAF) has recently begun the process of preparation for the IACS and a new farm registry.
- **Establishment of an Agency or Department for Rural Development (ARD) would facilitate the implementation of a coherent rural**

**development strategy.**<sup>192</sup> The experience of both existing EU Member States and current applicants suggest the need for extensive training and assistance in supporting the preparation and implementation of rural development projects and activities at the local level. To overcome these difficulties, several governments have established Agencies for Rural Development (ARD), either as part of the MAF or as independent nonprofit organizations under the guidance and funding of the MAF. The ARD should be tasked with coordinating implementation of a coherent rural development strategy and supporting activities that promote sustainable, and balanced socio-economic development of rural settlements, generating employment, and additional sources of rural income, assisting rural entrepreneurship and helping villages prepare and realize development projects. The role of such an agency, notably in the preparation and implementation of rural development projects and activities at the local level, is fundamental to fostering rural development.

- **A unified veterinary and food control authority in line with EU policy would eliminate overlapping and improve efficiency.** None of the various agencies engaged in food safety and inspection focuses exclusively on food control and food safety issues throughout the distribution chain and across all product sectors. This situation has been faced by most EU nations, leading many to adopt the strategy of a single agency with sole responsibility for food safety matters including food processing, border inspection, monitoring of residues and inspection at markets. *This reform would also lead to a more homogeneous set of principles and processes and, therefore, to simpler and better-integrated food testing procedures across the whole food chain.* The harmonization of inspection standards, through common training, standard inspection guidelines, internal quality assurance and periodic benchmarking exercises would be an additional benefit of a common, focused management structure. In addition, putting the whole process under the supervision of a single authority would concentrate the responsibility and facilitate the decision making process; and the creation of a single body should facilitate the implementation of the relevant *acquis* for food safety and inspection of foodstuff and provide the EU authorities with a clear counterpart to address any food safety issues.
- **Several barriers to the free movement of food products will need to be removed.** Notably, the food quality standards and certification requirements will need to be integrated with those of the EU in such a way to allow free movement of food products originating from the EU.
- **Reorganizing the provision of animal husbandry services by reducing the public role and eliminating current overlapping would increase efficiency.** The current provision of animal husbandry services in Croatia and the management of livestock records are split under the responsibility

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<sup>192</sup> Croatia is currently working with the Food and Agriculture Organization to formulate a rural development strategy.

of two separate parastatal companies, the Croatian Center for Reproduction in Livestock Breeding and the Croatian Livestock Selection Center, with significant overlapping. The inefficiency associated with the overlapping should be eliminated by reorganizing the institutions and establishing a single livestock register. As farmer association membership expands and associations consolidate in the coming decade, farmers associations will likely take control of animal testing, as has occurred elsewhere.

- **Establishing a single, central agency to manage plant protection and adopting EU phytosanitary standards.** Only the Plant Protection Law (1987), which conforms to the International Convention for the Protection of New Varieties of Plants (UPOV), currently meets EU norms. Croatia also lacks a single, central agency, under the control of the national Government, to manage plant protection under EU standards. Such an Authority for Plant Health should become a state-funded one-stop-shop for plant health inspection, survey, management and certification, and should also be responsible for plant protection product monitoring and testing, and for residue testing. Croatia should also aim to the early adoption of the minimum legal plant protection requirements and procedures of the EU. This would involve preparing, using the same definitions of terms as in the EU legislation, general legislation for plant varieties, seeds and planting materials, plant health (harmful organisms), plant protection products, and pesticide residues, supported by detailed secondary legislation.
- **Promote and facilitate the creation of farmers association (based on voluntary membership).** Agricultural growth will be enhanced if farmers associate to provide services and seek representation in the market and at the political table, acting in their own interests, as farmers and members of rural communities, rather than in the pursuit of narrow vested interests as is so often the case today with existing organizations.
- **Adoption of EU standards will require a profound transformation of the current surveys in the areas of agriculture, forestry and fishing.** The Croatian Central Bureau of Statistics (CBS) has joined the arrangements made by Eurostat for candidate countries to develop their statistics on agriculture, forestry and fishing to meet EU requirements. Adoption of EU standards will require a profound transformation of the current surveys in the areas of agriculture, forestry and fishing given the different concept of these statistics as well as the fact that the data previously collected had concentrated on physical quantities, without monetary values.

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