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ACRONYMS AND ABBREVIATIONS

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

OECD	Organization for Economic Cooperation and Development	TINA	Transport Infrastructure Needs Assessment
PBZ	Privredna Banka Zagreb	TPA	Third-Party Access
PCO	Pan-European Cumulation of Origin	TTFSE	Trade and Transport Facilitation in Southeast Europe Program
PIFs	Privatization Investment Funds	UCTE	Union for the Coordination of Transmission of Electricity
PSE	Producer Support Estimate	ULC	Unit Labor Costs
R&D	Research and Development	UNDP	United Nations Development Programme
SAA	Stabilization and Association Agreement	USAID	United States Agency for International Development
SEECs	South-Eastern European Countries	VET	Vocational Education Training
SIGMA	Support for Improvement in Governance and Management	VSE	Varazdin Stock Exchange
SOEs	State-owned Enterprises	WBES	World Business Environment Survey
TERFN	Trans-European Rail Freight Network	WTO	World Trade Organization
		ZSE	Zagreb Stock Exchange

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The core team was led by Helena Tang (task manager until the end of the mission in May 2002) and Daniel Oks (task manager until completion of the Report) and included the following World Bank staff: Bruce Courtney (macroeconomics), Sanja Madzarevic-Sujster (fiscal policy), Jan Rutkowski (labor markets), Csaba Csaki (agriculture), Rapeepun Jaisaard (agriculture), Antonio Nucifora (agriculture), Anil Markandya (environment), Sue Berryman (education), Ivan Drabek (education), Charles Woodruff (investment climate). The rest of the core team included the following consultants: Nevenka Cuckovic (privatization), Kresimir Jurlin (trade and FDI), Andrew Lovegrove (finance), Hernan Fuenzalida (labor law), Oxford Economic Research Associates, U.K. (transport and energy), Gordon Evans (public administration reform), Stjepan Tanic (agriculture), and Thomas Herzfeld (agriculture). Valuable comments were received from Kyle Peters, Bernard Funck (Sector Manager), Helena Tang (as adviser), Indira Konjhodzic, Katarina Mathernova, Manuel Marino, Irina Kichigina, Andrej Bolfek, and Harry Broadman. Mariela Alvarez, Nancy Davies-Cole, Usha Rani Khanna and Kathryn Rivera helped with the final editing. Carlos Silva-Jauregui was the peer reviewer.

ABSTRACT

Croatia's economy has undergone profound transformation since the country gained independence. Market laws and institutions have been introduced and the enormous real output decline of the first war-torn years of independence have been virtually recuperated. These achievements have been made despite a highly unstable geopolitical environment. The current government elected in 2000 has accelerated this transformation by opening Croatia to global markets through WTO and CEFTA memberships, cooperation with the South-East European neighbors and, especially, signing of the Stabilization and Association Agreement (SAA) with the EU.

The trade liberalization component of the SAA ties Croatia to an emerging European-wide free trade area and provides an opportunity to boost FDI and trade flows. Croatia depends critically on trade liberalization and foreign investment to stimulate competition, introduce new technologies, and increase productivity in order to sustain growth. The benefits of the SAA go well beyond trade. The SAAs are comparable in many respects to the Europe Agreements (EAs) that were signed between the EU and the 10 CEECs prior to their becoming candidates for EU accession. As with the EAs, the SAAs provide a framework for European integration. It is the process of bringing laws, institutions and policies in line with the EU's *acquis communautaire* that exerts the greatest integration impact. The SAA represents an opportunity as well as a challenge for Croatia's next round of structural reforms.

For Croatia, the challenge is to create conditions that will attract investment and produce growth. These *conditions* can broadly be categorized as (a) stable, progressive and predictable laws and institutions; (b) efficient labor and financial markets; (c) macroeconomic and financial stability; (d) social and environmental sustainability; (e) effective integration into the European infrastructure networks ensuring competitive cost and quality; 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. This Report proposes a reform strategy for faster economic growth through European integration.

To unlock the growth potential of Croatia reforms must be undertaken *which will complete the transition to a modern market economy*. Croatia has made substantial progress in adopting market and EU compatible legislation and regulations, reforming its banking sector, liberalizing its trade and in general creating conditions for the private sector to develop. However, the following core weaknesses remain: inadequately established property and creditor rights, a poorly functioning judiciary combined with weak governance, and rigid labor markets. The Government has initiated some steps in addressing each of these issues but will need to sustain its efforts in implementing reforms in these areas. These core problems account for limited enterprise restructuring and slow job and new business creation. Unemployment at 15 percent remains a key social and economic concern.

In addition, *fiscal reform* is necessary to provide a stable policy and macroeconomic framework to support the incentives that would be created by microeconomic reforms aimed at fostering investment and an efficient allocation of resources. High levels of public expenditure, fiscal deficits, and growing debt expose Croatia to potential macroeconomic instability. The Government may need to pursue more rapid fiscal adjustment than it has over the last years. This would dispel fears of debt sustainability and thus, indirectly, ensure financial stability. Reducing the pro-cyclical biases in fiscal and financial sector policies and institutions would reduce Croatia's vulnerability to shocks. With a highly euro-ized financial system, exchange rate stability is key to the stability of the financial system.

An efficient *public administration reform* is necessary to ensure that the adoption of the numerous new laws and regulations envisaged will be effectively implemented. Such a reform would also improve the Government's policy management capabilities. A modern and efficient public administration is also critical to develop institutional capacities that will ensure implementation of Croatia's commitments under the SAA, including approximation of the *acquis*.

Other key inputs for creating a favorable investment climate and consolidating growth prospects include skilled labor, efficient financial markets, and high-quality/cost-efficient infrastructure services. Croatia has already achieved substantial progress in these areas. However, pursuing reforms in these sectors would not be costly and would be good for growth and European integration. Thus, higher education reform should be pursued, as should reforms to create market-oriented infrastructure institutions as envisaged in EU Directives, including the institutional development of regulators and the strengthening of the competition agency. The highly competitive European environment requires, in particular, well-focused training and higher education programs that offer firms qualified staff and adequate skills for an innovation-driven knowledge economy. The further deepening of financial markets, which is closely connected to the reforms in the legal and institutional framework outlined above, ought to focus also on the strengthening of the regulatory and supervisory functions, particularly in the non-banking sectors. Similarly, market-oriented energy, transport, and communications are crucial to enhance the global competitiveness of the Croatian economy and to foster its integration into the European economy while creating opportunities for FDI.

While the Report 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 for meeting EU requirements. In the case of the environment, a sequence of implementation of EU directives is proposed that will strategically phase in investments, giving priority to those whose tangible benefits would accrue over the short to medium term. The environment reform agenda is also driven by efficiency considerations aimed largely at the introduction of 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 bring down 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. There is a strategic urgency to accelerate the pace of institutional and human capital development in both the environment and agriculture sectors.

SUMMARY REPORT

A. INTRODUCTION

- 1. Croatia has undergone a profound economic and institutional transformation since its independence.** Consolidating itself as an independent nation led to a war with all the associated social and economic costs. Output collapsed by at least one-third. Peace was, initially at least, expensive in terms of investment for reconstruction, the cost of mitigating the social consequences of war and overcoming hyperinflation. By now, Croatia has virtually recovered its pre-independence level of output. This achievement cannot be overemphasized in view of the highly unstable geopolitical environment and costs of transition from its socialist past into a market economy.
- 2. Progress has been considerable both from a regional perspective, in comparison to the other South-East European countries (SEECs), and from a historic perspective – the situation five or 10 years ago.** Croatia has introduced market laws and institutions including: liberalization of trade, privatization of state-owned enterprises (SOEs), the restructuring and privatization of its banking sector, the adoption of a legal framework to protect property rights, new labor and environment legislation, and new laws and regulations to increase the role of the private sector in infrastructure development.
- 3. Croatia's reforms still lag, however, in many areas behind those in Central and Eastern European countries (CEECs). Throughout the 1990s, Croatia was characterized by the dominance of large unstructured enterprises.** As with the other countries of former Yugoslavia, where prior to transition enterprises were predominantly socially-owned, 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. Due to incomplete privatization (dominated by insiders) and inadequate incentives for enterprise restructuring, the share of the private sector in the economy has remained relatively low. Rigid labor laws hamper job creation and remain a factor behind Croatia's high unemployment rate. While laws to protect property and creditors exist, their enforcement is still costly and often uncertain and bankruptcy procedures remain inefficient. Real estate ownership is not well established due to significant problems with the cadastre and land registration, although important initiatives to deal with these problems are underway. Public administration has not undergone the level of institutional development required for effective implementation of the many modern laws and regulations that have recently been adopted. Weak public administration is at least partly responsible for the enormous size of Croatia's public expenditure.

4. **The Government elected in early 2000 has set the stage, through its regional and European integration initiatives, for a new round of structural reforms.** The new Government has opened Croatia to global markets through WTO and CEFTA memberships, cooperation with the South-East European neighbors and signing of the Stabilization and Association Agreement (SAA) with the EU. The SAA evolved out of the Stabilization and Association Process which provided the policy framework of the EU towards the countries of the Western Balkans. The SAAs are comparable in many respects to the Europe Agreements (EAs) that were signed between the EU and the 10 CEECs prior to their becoming candidates for EU accession. For the 10 CEECs, the EU integration process began in earnest with the signing of the EAs. The CEECs integration with the EU through the EAs went well beyond trade. The process of bringing laws, institutions, and policies in line with the EU's *acquis communautaire*¹ has exerted the greatest development and integration impact on accession countries. This set the stage for boosting inflows of foreign direct investment (FDI) toward CEECs and their integration in the trade, production, and financial web of EU firms.

5. **Similarly, implementation of the SAA is likely to boost FDI and trade flows in Croatia partly through trade but more importantly by providing the framework of convergence with the *acquis*.** The signing of the SAA facilitates the integration of Croatia into the free trade area that is emerging across much of Europe. Croatia has signed Free-Trade Agreements (FTAs) with 35 European countries (after joining CEFTA in March 2003, some of them were superseded by the single FTA with CEFTA members) over the last two years. The significant removal of trade and investment barriers is likely to have strong dynamic effects on investment and trade flows in the region. But the ultimate purpose of the SAA is to permit Croatia (and all the other SEECS who sign similar agreements) to draw on the EU practice to better design its laws and institutions to facilitate the free movement of goods and the movement of services, capital and workers across Europe. SAA objectives also include asserting the rule of law, respect for individual rights, modernization of policy processes and strengthening the overall viability of the State. It is a unique opportunity to become geographically attractive for FDI that can simultaneously foster regional integration and ensure fast convergence with the EU.

6. **The challenge for Croatia is to create conditions that will attract investment and promote growth.** 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 the European infrastructure

¹ 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."

networks ensuring competitive cost/quality; 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. The SAA requires that Croatia adopt the *acquis communautaire* that provides an excellent benchmark for the laws, regulations, and institutions necessary to create these conditions.

7. **This Report focuses 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 that 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 that correspond better to highly developed economies. The Report thus 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. THE INTEGRATION AND GROWTH STRATEGY IN A “NUTSHELL”

8. **The core of the diagnosis presented in this Report is that inadequately established property and creditor rights, a poorly functioning judiciary and soft budget constraints account for limited enterprise restructuring and 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 of the labor force and no definitive trend towards reducing this rate, unemployment remains a key social and economic concern.

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

10. **The other key inputs for fast and sustainable growth are skilled labor and high-quality and cost-efficient infrastructure services.** Thus, the importance of higher education reform and market-oriented infrastructure institutions as envisaged in EU Directives, including the institutional development of regulators and the strengthening of the competition agency. The highly competitive European environment requires, 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.

11. **Croatia's deeper integration into Europe will further foster FDI, competition and knowledge transfer.** Croatia's trade liberalization strategy has been driven by the SAA with the EU, by the WTO, and by bilateral FTAs with CEECs and SEECs. By May 2004, after EU enlargement, the EU will account for almost 70 percent of Croatia's trade and, when the transitory period under the SAA is over, tariffs on this 70 percent of trade will be set to zero. There is still room, however, for broadening trade liberalization further by lowering tariffs to most-favored nation (MFN) trade partners not covered by FTAs to EU levels. Similarly, (assuming that Croatia undertakes the necessary actions to strengthen customs administration), participation in the Pan-European system of diagonal accumulation of origin (PCO system) would likely boost FDI and have a sizable impact on trade, productivity, and growth.

12. **The proposed microeconomic reforms must be embedded in a stable macroeconomic and financial framework.** In Croatia, this will imply addressing the *fiscal issue*, 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 addressing financial *stability issues*, especially prudential regulations and banking supervision to rein in the fast credit growth and preventing any potential exchange rate volatility from eroding the quality of bank balance sheets (in this regard, some important measures have already been taken). 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.²

C. CRITICAL BOTTLENECKS FOR SUSTAINABLE GROWTH

13. Croatia's key constraints to this strategy are as follows:

- **Despite ongoing fiscal adjustment efforts, Croatia's macroeconomic framework remains vulnerable.** The primary fiscal deficit consistent with debt sustainability is at least 2 percentage points lower than the one observed in 2002. An exceedingly large public sector (public expenditures are more than 50 percent of GDP), large public sector deficits (averaging 6.5 percent of GDP between 1999-2002) and high public debt leave the economy vulnerable to adverse shocks. In the presence of such shocks, the economy could fall into a vicious cycle of explosive public debt growth, low private investment, and low growth leading to both macroeconomic and financial instability. An unstable macroeconomic framework acts as a

² 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 by the recent Poverty Assessment and Public Expenditure Review.

major disincentive for investment in the production of goods, factors, services, or human capital.

- **The privatization strategy chosen in the 1990s has not been conducive to enterprise restructuring and job creation;** it has also discouraged foreign investment. As with the other countries of former Yugoslavia, where prior to transition enterprises were predominantly socially-owned, the privatization process undertaken by Croatia gave overwhelming preference to manager and employee buy-outs. The dominance of these large enterprises in a non-competitive environment has discouraged the emergence of small and medium enterprises. Large enterprises with insider owners, such as the privatized *agro-kombinats* (AKs) are able to mobilize strong political support in opposition to any take-over bid by a strategic investor. SOEs 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.
- **There has been a propensity to “protect” jobs through expensive employment protection programs or through subsidies to loss-making SOEs.** The problem with labor-protecting legislation has been that—beyond certain limits needed for social protection—it often ends up restraining demand for labor thus hampering unemployed, enterprise restructuring and job creation. Similarly, the problem with the privileges awarded to SOEs and, in particular shipyards, rails and agro-processing firms (both through explicit transfers and through exemptions from fiscal obligations, soft loans and discriminatory protection) has been that, while they may appear to protect jobs, they tend to have precisely the opposite effect. By delaying SOE restructuring and by preventing the development of a level-playing field for private investment, these policies discourage new firm entry, existing firms’ expansion, and sustainable job creation.
- Despite significant progress towards putting in place the legal and institutional framework necessary to support a favorable investment climate, **legal uncertainties concerning property rights (notably linked with the land registry and cadastre) and their enforcement through the judicial system constitute a major impediment for new investment.** Unenforceable creditor rights severely constrain financial intermediation critical for enterprise restructuring. The dilution of creditor’s rights in bankruptcy proceedings is yet another factor accounting for limited investment and enterprise restructuring.
- **Croatia’s public administration and judicial system lack the human and institutional capacity to implement and enforce the proposed laws, regulations, and policies.** Too often laws and regulations exist but they are not applied due to lack of understanding on the purpose and application of the law, lack of incentives for compliance and/or enforcement, politicization of civil servants, etc. Similarly, Croatia’s civil service has demonstrated insufficient capacity to prioritize investments

and reforms and to properly discriminate least-cost and more efficient market-compatible solutions to the provision of public goods. This is very costly both fiscally and economically. Also, the poor functioning of the judiciary hampers enterprise restructuring, financial market development and the investment climate in general.

14. The next section examines how to tackle those five bottlenecks.

D. TACKLING CONSTRAINTS TO GROWTH

Macroeconomic and Fiscal Strategy

15. **Successful macroeconomic stabilization policies and improved security laid the foundations for economic recovery in 1994 following a cumulative 36 percent decline in real GDP between 1990 and 1993.** Between 1994 and 1997, GDP growth averaged 6.4 percent driven mainly by domestic demand, with investment dominated by post-conflict reconstruction activities. The improved economic situation in Croatia spurred large inflows of capital that financed the imports of reconstruction and consumption goods. Gross investment almost tripled between 1993 and 1997 to 27.5 percent of GDP.

16. **However, rapid credit growth, rising public expenditure and strong wage growth financed an unsustainable expansion in aggregate demand that led to a double-digit current account deficit in 1997.** 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. And general government expenditure—driven by reconstruction activities and increases in wages and social spending—rose from 44 percent of GDP in 1994 to 57.2 percent of GDP in 1999.

17. **The Croatian authorities were reluctant to tighten fiscal policy or rein in fiscal expenditures.** 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. The recession in late 1998 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 public spending spree in the 1990s was made possible partly by significant revenue mobilization. However, the GDP contraction in 1999 led to lower tax revenues and higher subsidies and transfers, resulting in a deterioration of the fiscal deficit to 8.2 percent of GDP. The broadest measure of public debt (including government guarantees and arrears) rose by more than 20 percentage points of GDP between 1995 and 1999.

18. **The new Government in 2000 envisaged fiscal adjustment, wage restraint, and an acceleration in the pace of structural reforms.** The authorities moved quickly to further restructure and privatize the banking sector and to liberalize its trade regime. In 2002, the Government introduced a multi-pillar pension system including a funded private second pillar mandatory for workers less than 40 years of age. Fiscal tightening

paved the way for lower interest rates and business and consumer confidence improved leading to a recovery of private aggregate demand. The growth of net export in turn, facilitated by the recovery in Europe, past real effective exchange rate depreciation and recovery in tourism, also contributed to growth which averaged about 3.5 percent in 2000-02. The exchange rate has remained fairly stable while the inflation rate was low. The recovery of confidence in the banking system, fiscal tightening and growth in tourism revenues helped reduce the current account deficit as international reserves soared.

19. **Despite progress, (the budget deficit was reduced to less than 5 percent in 2002) expenditures remain too high, over half of GDP, and the public debt to GDP ratio continued to rise, reaching around 43.6 percent of GDP in 2002.** In fact, the ratio of public debt to GDP has risen every year since 1995. 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 and, along with it, if the marginal cost of borrowing jumps. Failure to adjust could put at risk not just sovereign solvency but also the growth strategy, as rising country risk premia would deter private investment in new projects.

20. **The source of fiscal problems is that consolidated government expenditure expanded by more than 18 percentage points of GDP between 1991 and its peak in 1999.** The subsequent reduction of public expenditure amounting to 3.8 percent of GDP in 2001 was partly offset by reduced tax pressure, a 2.2 percent of GDP drop in revenues between 1999 and 2001, mostly due to lower profit and payroll tax rates. As a result, the fiscal deficit fell to 6.8 percent of GDP in 2001. The fiscal balance was reduced further to 4.8 percent of GDP in 2002 due to a continued reduction in expenditures. Even after the sizable expenditure reductions in 2000-02, on wages, current, and capital expenditure, government expenditure represented 51.7 percent of GDP in 2002. Croatia has one of *the largest public sectors in the world*.

21. **Financing of large deficits, on average around 6.5 percent of GDP in 1999-2002, combined with large quasi-fiscal expenses has led to rapid debt accumulation.** 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, and 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 AKs. The share of public sector 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 public debt, the stock of public debt increases from 30.3 percent to 60.6 percent of GDP*. In contrast, on average, accession and EU countries have in the last six years (1995-2001) succeeded to reduce the public debt level by 3.3 percentage points and 8.3 percentage points 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.

22. **At current levels of debt, a continuation of large primary fiscal deficits, on average 3.6 percent of GDP in 2001-2002, would lead to explosive debt growth.** 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, well below the current level.*

23. **The Government's three-year fiscal program envisages a 2 percentage point of GDP reduction of public expenditures over the 2003-2005 period.** Under the assumption of average annual growth of 4.5 percent and inflation of around 3 percent, expenditure restraint is expected to lead to a similar reduction of the primary deficit (excluding privatization proceeds) to 1.1 percent of GDP by 2005. *The fiscal adjustments envisaged by the Government fall short of what is needed for debt sustainability.* Even under the relatively optimistic growth assumptions used by the Government, the required primary deficit for debt sustainability is about one-third of the average primary deficit envisaged for 2003-05.

24. **To restore debt sustainability, Croatia ought to consider pursuing a more rapid fiscal adjustment strategy.** For example, it could pursue an anti-cyclical primary fiscal balance rule such that during the upswing Croatia runs primary fiscal surpluses and during the downswing it runs deficits. Since privatization revenue will diminish substantially after 2005, and since tax pressure is already very high (9 percentage points of GDP higher than the average CEECs and about the same as the EU-15 average level) **bringing the fiscal deficit down to a sustainable level would require further reductions in public expenditures.**

25. **Cross-country international comparison suggests that there is scope for significant reductions in public health, social security, and transport spending.** In the case of health, and despite recent reforms, short-term savings are unlikely in part because of the need to compensate for deferred maintenance costs during the last decade. Revenues may improve though through measures aimed at improving compliance, the introduction of supplementary health insurance plan and more use of cost-sharing arrangements.³ Social security is high and rising beyond the EU average. The social welfare system suffers from inadequate targeting and overlapping of benefits for which rationalization could bring significant savings and improvement of services, particularly, transfers to veterans should be carefully examined. In the case of transport, an ambitious investment program into roads and highways has driven public spending to 2.5 percentage points of GDP higher than in comparable countries.

26. **There is also scope for lowering public sector wages, subsidies and transfers.** While the share of public sector wages and salaries in GDP has recently been brought back to around the 1997 level, there is still scope for further reductions; it represented 11.2 percent of GDP in 2002 compared to an average 7.2 percent of GDP in the CEEC.⁴ Subsidies and transfers including those to railways, shipyards, the Postal Bank,

³ A detailed strategy is provided in *Croatia Health Finance Study*, World Bank, 2002.

⁴ Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia, and the three Baltic countries.

agriculture and pensions increased 2.4 percentage points of GDP in 1997-99; and kept rising, albeit at a moderate pace, until 2001. While some reductions were attained in 2002, there is still scope for reducing their share in GDP by about 2 percentage points to get back to the 1997 level. Over the medium term, this is the most likely source of expenditure reduction. Similarly, the call rate of government guarantees has been increasing (since 1998, a total of 1.5 percent of GDP has been spent on called guarantees); fiscal adjustment requires tightening the issue of new guarantees and the criteria and price at which they are issued.

27. Over the 2003-08 period, the financial requirements associated with the European integration and growth strategy proposed in this Report could be costly. However, depending on how investments and reforms are implemented, they can also generate sizable revenue gains that to a large extent pay for themselves. The budgetary impact of an illustrative medium-reform scenario presented in the main report for 2003-2008 would *average 5.8 percent of GDP annually*. By far the biggest item is investment in highways until 2005 for which the scenario adopts the Government's own ambitious projection. Similarly, the simulation computes estimates of the transition costs of pension reform. Other expenses include environmental investments, severance payments, educational reform, and lower trade taxes. Estimated gains are almost as large – *5.2 percent of GDP on average*. Sources of revenue include tolls and excises for motorway construction; privatization receipts and reduction in public administration staff and freeze on wages over 2003-04. Other relatively less important gains are projected to accrue from savings in defense, improved compliance with payroll taxes, reductions in reconstruction activity after 2004, and environmental fees, among others.

28. The impact on debt sustainability of the integration and growth strategy proposed is highly contingent on the economy's projected growth performance. Under fast growth scenario, the debt-GDP ratio declines throughout the period, albeit at a modest speed; the primary balance only attains levels compatible with debt sustainability in 2006-08; the debt ratio falls in 2003-05 due to sizable privatization receipts until 2005 (the scenario crucially assumes that privatization revenues will be used to reduce debt and that the stock of guaranteed debt will be held nominally constant).

29. Under the low growth scenario (2.5 percent annually), a smaller reduction in subsidies and transfers leads to larger fiscal deficits and thus to an increase in the debt ratio over 2003-05. Whether the Government succeeds thereafter in stabilizing its debt relative to GDP will depend strongly on its capacity to carry out deeper cuts in other, perhaps strategic, expenditures like capital expenditures. Prudence would call for an earlier and *faster reduction of the primary deficit*.

Governance, Enterprise Restructuring, Privatization, and Firm Entry

30. 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 processes is far from complete, and progress in restructuring has been disappointing overall. 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. Moreover, 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. There has been some progress in privatization during 2001-02. According to the Croatian Fund for Privatization (CPF), only 178 companies remain with majority state-ownership 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 addition, there are over 900 firms where the State holds up to 50 percent of the shares.

31. Many Croatian enterprises continue to operate while generating losses, defaulting on debts to banks, and accumulating arrears with other enterprises. On average, both SOEs and (large) privatized enterprises incurred net losses in every year between 1996 and 2000 (except privatized firms in 2000). Owner-led restructuring seldom occurs in employee-owned enterprises. In 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 Banking Restructuring Agency (BRA) which has claims totaling HRK26 billion on around 700 enterprises and is the majority creditor in around 75 percent of these enterprises. The 1998 Bankruptcy Law required enterprises delinquent in their payments by more than 60 days to file for bankruptcy. Over 32,000 enterprises are required under this law to file for bankruptcy. However, as is the case with many other Croatian laws, compliance has neither been monitored nor enforced. Most of these companies have not yet entered the bankruptcy process.

32. Priority measures to accelerate enterprise restructuring and improve the effectiveness of privatization would include:

- **Reviewing privatization transactions involving fraudulent deals to ensure clear legal rules and effectively monitoring future transactions.** Corruption, violation of ownership rights, and other norms in the process of privatization should be resolutely sanctioned. BRA should sell its assets to a private asset management company that will be less constrained by political considerations.
- **Strengthening corporate governance,** including SOEs, through the development of crucial capital market institutions and the adoption of principles of corporate behavior based on best practices and rules of EU countries and OECD Corporate Governance Principles and Codes. Specific measures to improve enterprise governance include: public disclosure of ownership holdings in excess of 3 percent; appointment of independent members to supervisory boards which may own no more than say 5 percent of the company's shares and play no role in the executive management of the company; disclosure standards for large firms, regardless of the listing of a firm in capital markets.
- **Abandoning the practice of bailing out companies** at the taxpayers' expense through subsidies from the budget, writing off of debts to the State, tax breaks, or exemption of payment of pension and health insurance contributions.

- **Enhancing the legislative framework for firms' exit** through stricter implementation and amendments to the present Law on Bankruptcy that would strengthen the capacity, authority, and efficiency of Bankruptcy Courts.

33. **Measures should also be undertaken to facilitate private firm entry. The dominant trends in employment and productivity show that by far the most dynamic sector has been the private (non-privatized) sector made up mostly of SMEs.** Between 1996 and 2000, while there was a 27 percent reduction in SOEs' employment and a 14 percent decline in employment by privatized enterprises, employment by private companies increased 50 percent. 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. The SME sector has also been the one whose productivity grew faster: its labor productivity increased 46 percent compared to an average 28 percent for the entire enterprise sector during 1996-2000.

34. **However, the "de novo" private (non-privatized) sector still only accounts for about 35 percent of the value added and owns fewer than 30 percent of the assets of the enterprise sector.** Much of the dynamism of Croatia's economic growth and employment potential will thus depend not just on the efficiency of the exit mechanism for large enterprises but also on the ease with which new businesses can be created.

35. **Simplified procedures and improved coordination between government agencies could be pursued to facilitate the creation of new businesses, involving:**

- Updating Land Book records and accelerating new owner title registration to reduce the difficulty of ascertaining the ownership of land and property and the long procedure of owner title registration.
- Adopting 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.
- Adopting the Law on Public Utilities Management that would define time limits and provide for same conditions for connection of utilities and support solutions of the Law on Physical Planning.
- Adopting the Construction Law that would define the procedures for the issuance of building permits.

The Government has recognized the need to address many of the issues listed here and has already drafted much of the necessary legislation. The enactment and proper enforcement of such legislation will be key to facilitating the creation of new businesses.

Reducing Labor Market Rigidities to Foster Job Creation

36. **With an unemployment rate of 15.2 percent,⁵ 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.** This implies 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 started in 1996, when the inflow into the pool of unemployed began to exceed the outflow from unemployment, and accelerated after 1998.

37. **The low employment-to-population ratio is a result of key factors that distinguishes Croatia from an average OECD country:** an extremely high youth unemployment (36.6 percent); a low labor force participation of young persons (aged 15-24); and a 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. *These characteristics of the labor market are typical of other transition economies with inflexible labor markets.*

38. **The low employment-to-population ratio in Croatia (as in many CEECs), reflects a mode of labor market adjustment to supply and demand “shocks” in which the brunt of adjustment has been borne 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 percentage points, while real wages have grown by about one-third alongside productivity (in industry). For many firms, especially the privatized ones, downsizing has become a prerequisite for survival in a more competitive environment. The 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.

39. **Enterprise restructuring has given rise to accelerated inflows into unemployment.** Since the excess of inflows into unemployment over outflows from unemployment has persisted since the mid-1990s, the result has been a gradual build-up of unemployment from 240,000 in 1995 to 410,000 in early 2002. 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*

⁵ 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, thus, is that the unemployment register data significantly overestimate the level of unemployment (by nearly 50 percent).

Croatian economy? Why does the Croatian economy not generate a sufficient number of jobs to offset the negative impact of enterprise restructuring?

40. **Barriers to entry of new firms and barriers to expansion of employment in existing firms is the most direct response. Business start-ups create about one-third of new jobs in the economy, as observed in a number of transition economies, such as Bulgaria, Lithuania, and Poland.** 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 an 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 increasing the number of small private firms is already under way in Croatia. However, the rate of new enterprise growth was insufficient to offset the employment reductions taking place in existing firms.

41. **The slow pace of job creation, and thus high unemployment, can also be traced back to strict employment protection legislation.** Croatia has one of the strictest employment protection regulations in Europe and among the OECD countries. 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).⁶ According to it, employment protection legislation is stricter in Croatia than in any transition economy accessing EU and stricter than in virtually all EU and OECD economies. EPL in Croatia is much stricter than in countries characterized by low unemployment and flexible labor markets. For example, the summary EPL index was 1.1 in Ireland and 1.7 in Hungary, compared with 3.6 in Croatia.

42. **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 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 CEECs.

43. **In addition, job creation is slowed down by high unit labor costs arising 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

⁶ 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 contracts 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).

benefit system, the wage structure, enterprise restructuring and associated skill and spatial mismatches appear at best to play a secondary role.

44. **Reforms of the employment protection legislation and of the wage bargaining system are thus key for improving labor market performance in Croatia.** 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:

- **Lowering costs of individual dismissals** by shortening the notice period and lowering the statutory severance pay.
- **Relaxing restrictions on the use of fixed-term and temporary contracts.**
- **Institutionalizing temporary work agencies.**
- **Revising the definition of collective dismissals** in line with EU directives, and restrict special regulations so as to apply only to large firms.
- **Decentralizing industrial relations,** in particular move away from industry level bargaining toward firm level bargaining.

Legal and Institutional Framework

45. **Perhaps the single most important weakness in the investment climate lies in judicial system.** This is particularly true in cases where regulatory agencies such as the Croatian Securities Commission and the APMC must refer their findings of illegal behavior to the courts for prosecution. It is also true in the case of insolvent enterprises. Widespread non-compliance with and non-enforcement of the law undermines the rule of law and breeds disrespect for the law.

46. **This is exacerbated by a lack of common judicial practices; 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. Some banks estimate that it now can take up to five years to execute a mortgage in the Zagreb courts.

47. **The Government is largely aware of the problems in the judicial system and has adopted a reform program to address the problem of Croatia's courts in accordance with the spirit of the SAA.** For example, with support from World Bank, 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.

48. **While the strategy to reform the judiciary ought to be broad-based, a key focus should be on the implementation of commercial laws.** The following actions are proposed to complement or deepen current initiatives as follows:

- **Increasing the efficiency of the legal system by** (a) introducing efficient court administration and court management systems; (b) introducing mandatory training for judges; (c) improving the 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) pursuing a more rational allocation of work between court personnel and the modernization of case management system; (e) reforming civil procedures; and (f) enhancing institutional independence by increasing the budgetary autonomy of the judiciary.
- **Reducing the backlog of cases before courts by promoting alternative dispute resolutions and out of court settlements.**
- **Creating greater legal consistency within the court system** by improving the system of judiciary guidelines on issues where there are variations in practice between court districts and within courts – such guidelines should be provided by upper courts and/or under special proceedings but not by the executive branch.

49. **Furthermore, property and creditor's rights are insufficiently protected.** Part of the problem is due to an outdated and incomplete land registration system that is unable to register changes in land ownership or liens on time. 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).

50. **Similarly, the lack of a national registration system for pledges on movable property such as equipment and cars exposes lenders to fraud (as there is no means for purchasers to quickly and cheaply check title to movable property).** This deficiency critically discourages the development of equipment and other forms of movable financing, such as accounts receivable and inventories. These are particular problems for SME lending since SMEs may operate out of rented premises and most of their assets may 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

51. **Debt enforcement procedures of creditor rights are hampered by the weak functioning of the judicial system and the bankruptcy process in particular:**

- **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 through frivolous appeals.
- **Lack of a functioning small claims court system.** The Croatian courts are clogged with about 1.2 million civil cases which are a drain on the limited resources of the court system – a small claims system exists but does not function.
- **Weakness of the bankruptcy process.** The bankruptcy law was reformed in 1998 but a functioning system has not yet emerged. 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.

52. **Reform of the framework for investor and creditor rights should be one of the authorities' highest priorities.** Specifically, urgent action is required to:

- **Update and computerize the land registry, bringing it into conformity with the cadastre,** and make registration procedures user-friendly, cheap, and efficient. The Government should seek and explore options, which might provide much faster progress than currently envisaged in this vital area. Croatia should develop and implement 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 receivable and crops.
- **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, eliminate the ability of debtors to use the legal system to delay proceedings, a streamlined procedure for the enforcement of unsecured debts (allowing creditors to force unsecured debtors into bankruptcy).
- **Reform the small claims procedure** and move it outside the regular commercial court system to allow for very fast resolution of minor disputes and claims while allowing courts to concentrate on larger cases.
- **Create a Council of Bankruptcy Administrators** as a quasi-judicial body with the ability to hear evidence of malpractice and the power to suspend unscrupulous or incompetent bankruptcy administrators.

Public Administration Reform

53. **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.** 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 nomenklatura system towards a modern civil service capable of facilitating Croatia's democratization process and its transition to a market economy. There was, however, some progress in the simplification of the internal structure of ministries and the reduction of managerial staff by about 60 percent. The most significant restructuring occurred at the local level with the massive expansion in the number of sub-national governments from 104 to over 560. *As a result, Croatia's public administration is expensive and its ministerial structure highly fragmented and poorly coordinated; in turn, its civil service is subject to political influence and lacks adequate skills and incentives to perform.*⁷

54. **Croatia's civil service remains ill equipped to deal with the combined challenge of structural reform and preparing for European integration.** The scope and complexity of reforms needed 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. Much of what is lacking at the central level is also lacking at the regional and local level. The poor functioning of the policy management function implies a limited capacity to strategize, prioritize, and effectively implement reforms. This is particularly visible in the budget formulation process, which, in turn, is so critical for the fiscal reform agenda. The Government has recognized the critical weakness in the capacity of its civil service and has started to design a reform of public administration.

55. **Croatia's public administration is expensive, fragmented, poorly coordinated and subject to political influence; a strategy to restructure and reform it ought to:**

- **Address wage and compensation policy** and assess its links with the budget plan.
- **Target priority areas (judicial, economic policy) and develop analytic capacity** to assess fiscal impact of reforms.
- **Modernize the civil service** which in turn requires linking hiring with merit, strengthening the human resource function, adopting a modern set of leadership competencies for senior management and integrating many high level positions to the permanent civil service.
- **Strengthen the policy management capacity** at the center of government.

⁷ The Government has recently signaled its intention to tackle civil service reform with the launching of the CARDS 2001 public administration reform project.

- **Extend the mandate of the inner cabinet coordination body** (chaired by the Prime Minister) to encompass strategic planning, policy management, budget and civil service reforms.
- **Ensure that the Ministry of Finance plays a proactive role in priority setting, integrating fiscal and policy planning** and impact analysis.

56. **If not managed carefully and sequenced correctly the scope of public administration reform could easily overload Government.** A package of reform would, however, need to be put in place first before any of the more sophisticated analytic tools or new public management methods are contemplated. Core recommendations are to:

- **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 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.** The weaknesses and under-funding in key areas within the Ministry of Finance need to be remedied on a priority basis. Capacity problems within central agencies such as the Ministry of Finance will impede policy reforms as the quality of the Government's policy management system depends on the effectiveness of its central agencies.
- **Initiate administrative consolidation.** The current mix of ministries/agencies and gaps in mandates produces policy fragmentation rather than coherence.
- **Develop a decentralization strategy.** 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 central to the design of an overall decentralization strategy, it would be useful if a position on amalgamation could be finalized.

E. COMPETING WITHIN EUROPE

57. **Croatia will need to redouble its efforts at strengthening overall competitiveness if it wants to compete successfully within Europe. Tariff dismantling as stipulated by the SAA and the results of WTO negotiations will obviously increase competitive pressures on Croatia's economy.** While Croatia has

gone a long way in liberalizing its own economy, developing its banking system and modernizing its infrastructure networks, there is still room for further developing competitive pressures through the strengthening of trade links with the world, reducing agricultural protection, the mobilization of savings towards high return investments, and the creation of opportunities for investment in infrastructure which is competitive in terms of quality and cost. To rise to the competitive challenge, Croatia will need as well to develop its human capital enhancing skills, attitudes, and mobility necessary to support businesses, which are internationally competitive. Catching up with EU levels of productivity will also necessitate the development, transfer, and adoption of new technologies and organizational processes. These are some of the most important factors of the *investment climate* that can at once encourage investment, job creation, and knowledge-based economic growth.

58. Improving the investment climate is one of the key elements of the SAA and is crucial to enhance Croatia's capacity to effectively compete on the increasingly integrated European market. This section discusses the **strategy** to improve the investment climate through: further trade and investment liberalization, agricultural policy reform, deepening of financial markets (particularly of non-bank intermediaries), reforms to higher education and R&D policies, and integration into the EU transport and energy networks. These aspects are examined in turn below.

Trade and FDI Environment

59. Croatia's merchandise trade performance has been disappointing. Total exports of goods and services have been growing steadily over the 1993-2001 period representing 46 percent of GDP in 2001. However, export growth can be ascribed almost exclusively to tourism revenues - service exports more than doubled during the period. Croatia traditionally had a significant surplus in trade in services mainly on account of tourism (US\$3.3 billion in exports in 2001). Merchandise exports in contrast have stagnated, resulting in a significantly reduced share in world trade receipts. Similarly, the share of Croatia in EU imports declined from 0.34 percent in 1993 to 0.19 percent in 2000; during the same period, the share of the CEECs almost doubled.

60. The relatively recent round of trade liberalization in Croatia is likely to have a strong positive impact on both trade and FDI performance. *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?*

61. Bilateral trade liberalization with the EU may not be the most important aspect of the SAA. Indeed Croatia already had MFN treatment in the EU for most products during the past decade. But the Stabilization and Association Process has given strong impetus to trade liberalization in all SEECs: Croatia itself has signed already 35 free trade partners (including all EU members through the SAA). Over two-thirds of Croatia's trade will be at zero tariffs once the transitory period under the SAA is over.

62. However, 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:

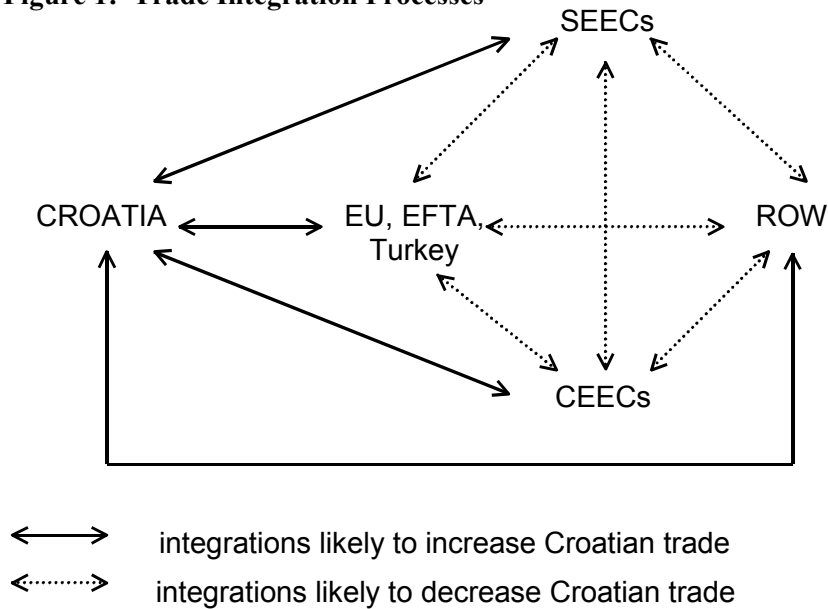
- Croatia and other SEECS have joined WTO⁸ and there is a framework of lowering the MFN tariffs on imports from the rest of the world, which shall diminish trade diversion towards third countries.
- All other countries of South-East Europe should eventually conclude an SAA with the EU, creating opportunities to increase their trade and investment flows with the EU.
- Croatia and the other SEECS 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 the emerging Pan-European free trade area.
- 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.⁹
- 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 should have no significant trade preferences in the EU markets compared to those other countries.

63. Figure 1 presents schematically the above processes indicating whether they are expected to stimulate or reduce Croatian trade. *Both quantitative and qualitative analyses¹⁰ suggest that aggregate trade will increase and with it the opportunities to reap the benefits of greater economic efficiency, welfare and growth:*

⁸ 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.

⁹ 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 the integration, the greater are the opportunities for trade and investment flows within that integration.

¹⁰ See Chapter 3, Section C in Volume 2 of this Report for a description and summary discussion of results.

Figure 1: Trade Integration Processes

Source: World Bank staff.

64. **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.** 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.¹¹ Note, however, that the EU already accounts for over 50 percent of Croatian trade and that this will keep growing. Croatia is in any case reviewing its MFN tariffs as part of ongoing WTO negotiations. Similarly, and despite tariff levels being relatively low on average, the asymmetric nature of the SAA could be unilaterally (at least partially) reversed. SEECs could also step up attempts to pursue more efficient multilateral trade liberalization arrangements, such as 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.

65. **Much of the dynamism exhibited by trade flows will hinge on the performance of FDI and investment.** The dynamic effects of trade will be largely achieved through FDI that brings capital, technology, knowledge, and opportunities for skills 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 among the more stable of capital flows (compared for example to portfolio flows). The investment climate and overall business conditions will thus be more important determinants of future trade

¹¹ MFN tariffs industry are however very low, around 3 percent on average, which implies limited scope for sizable reductions.

flows. The greatest impact of the SAAs will be provided by the assistance to align policies, legislation, and institutions with those of the EU.

66. **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 that simultaneously can preserve idiosyncratic features.** The CEECs also have benefited from participation in the Pan-European System of Diagonal Cumulation of Origin (PCO) system since 1993. This allows participants to export goods (under preferential terms to the EU) that employ inputs with content produced in any other country under the PCO System. The door is now open for Croatia to join the PCO, and Croatia would be well advised to focus on meeting entry criteria as soon as possible.

67. **With a cumulative FDI inflow in 1994-2000 estimated at US\$1,187 per capita,¹² Croatia already ranks high among the transition economies.** For example, by end-2000, Croatia was 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. 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.

68. **Unfortunately, “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. At 16 percent of exports, the share of FDI firms is low compared to the shares of CEECs – 60 percent for the Czech Republic and Poland, 89 percent for Hungary, 33 percent in Slovenia, and 35 percent in Estonia. 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 were into chemical products, non-metallic mineral products, food products and beverages, electrical machinery and apparatus and radio, TV, and communication equipment. The effects of FDI on exports of these manufacturing subsectors have not been significant.

69. **The driving force of FDI in Croatia has so far been 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

¹² 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).

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.

70. **The potentially crucial role of FDI in export-oriented activities in Croatia will depend, in fact, on whether it can enter the PCO system.**¹³ Current rules of origin requirements for preferential treatment in the EU fall short of providing Croatia the full benefit of free trade with the EU. Croatia should endeavor to meet the criteria for joining the PCO system as soon as possible. This would strengthen the economic relations between Croatia and the EU, due to the fact that the EU is Croatia’s largest trade partner and that a majority of FDI inflows originate in the EU.

71. **Various administrative actions can also play an important role in facilitating trade and FDI.** These include: visa and work permit procedures, custom’s arrangements, more efficient transport services, easing land acquisition and company registration. The Government has initiated measures that begin to address a number of these issues, though persistence will be required to ensure effective implementation. One area where more can be done is *custom’s arrangements* which may be improved through: better use of available software, dynamic border controls through random checks at border points, better coordination between custom officers and border police, speeding up the construction of new border crossings. Other actions include the strengthening of the Export Development Agency, for example, by pairing up its efforts with embassies and consulates to support private firms’ export efforts, particularly SMEs.

Agriculture Policy in a European Perspective

72. **With the signing of the SAA, Croatia faces the imperative of reorienting its institutional and policy framework for agriculture toward the need to compete on European markets. A whole cohort of reforms will be needed to create an internationally competitive agricultural sector.** Agriculture remains an important component of the Croatian economy, contributing 8.3 percent of GDP in 2001 (still above the CEECs average). Maize is the only crop for which yields have increased beyond the levels achieved in 1990; other crops remain around or below the yields obtained at independence. In most cases, yields are below those observed in the EU, although close to the average of CEECs. As with crop production, per animal production

¹³ 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. As a general rule (without cumulation), in the context of a preferential arrangement of the type applied by the EC, all materials imported from a third country for use in obtaining a product in the country of export must undergo sufficient working or processing in order for the product to be considered as originating. With the introduction of cumulation it becomes easier to obtain originating status for materials originating in the partner country, which no longer have to undergo "sufficient working or processing". Under bilateral cumulation (as applied between Croatia and the EC in their trade relations), each partner recognizes materials originating in the other partner as originating, provided they undergo only "more than minimal" operations. Under the Pan-European system of diagonal cumulation of origin, participants recognize materials originating in any other partner as originating, again provided they undergo only "more than minimal" operations.

is generally well below EU standards. In addition, livestock yields are significantly below those achieved by the CEECs.

73. **Small-scale private farms recovered quickly from the impact of war and have increased output steadily since 1992.** By 1998, their production exceeded the level achieved in 1990. 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 50-60 percent of independence levels in 1996 and 1997.

74. **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.

75. **Croatia's agriculture sector faces serious structural weaknesses.** Apart from distorted agricultural policies and high subsidization, discussed below, the following are most noteworthy:

- **Incomplete transition in farming.** 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. AKs have applied survival strategies based on payment arrears, soft state budgets, and bad debts; they also seem to have enjoyed more effective political representation and support that ultimately delayed rather than facilitated their restructuring.
- **Unsettled land ownership situation.** Currently, 30 percent of the agricultural area remains under state ownership and, for roughly 40 percent of the agricultural land area, the ownership remains unclear. According to government estimates, it will take up to 15 years to clarify all private land ownership disputes. As a result, land markets are barely functioning. 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.
- **Weak commodity markets.** The poor development of competitive agricultural markets at the wholesale level implies that commercial margins to the small farmer are often squeezed by monopolistic behavior of traders or large processors. One of the main characteristics of the Common Agricultural Policy (CAP) is the fact that price and market support is mostly done at the wholesale level and not at the farm gate. The competitive functioning of wholesale markets, therefore, is an essential prerequisite to the transmission of the CAP-like support to producers.

- **Lack of credit in rural areas.** Less than 1 percent of the total number of small farmers is currently borrowing 80-90 million kuna annually. Public schemes have had mixed results at best. 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, lack of provable title to land, the weak enforcement of contracts and bankruptcy procedures, and a culture of non-repayment of loans.
- **Poor representation of private farmers.** 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. In the EU, such representation is a crucial element for the implementation of the CAP. 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. 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.

76. **To make up for these structural weaknesses, Producer Support Estimates (PSE) for Croatian agriculture are high.**¹⁴ 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.*

77. **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. 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.

78. **The Government's expectations that increased support would reduce production costs and by extension, farm gate prices, and at the same time secure adequate income levels for farmers did not materialize however.** Since area payments were combined with the requirement to purchase the inputs from domestic producers and traders who, protected by tariffs, exhibited monopolistic behavior, the new scheme resulted in transfer of benefits to upstream and downstream sectors. Moreover, the arbitrary allocation of subsidized area quotas had the effect of perpetuating the existing

¹⁴ 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. 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.

production pattern. Small farmers who mainly produce for home consumption were excluded and the largest farms, as well as monopolistic processors and traders got most of the benefits.

79. **A new reform of agricultural support policies, which became effective in 2003, 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.

80. **Under the new reform, policy instruments are grouped in four categories:**

- A “production support scheme” (similar to the current one) for commercial farms consisting of annual area payments for arable and permanent crops and annual payments per livestock head.
- Capital investment grants for commercial farms (up to 25 percent of investment).
- An “income support scheme”—alternative to the production scheme—for non-commercial farmers who are at least 55 years or older (with an option to receive an annual lump-sum income support in place of area production subsidies).
- 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.

81. **Croatia’s agricultural policies are likely to experience further changes over the next few years.** *First*, a reform of agricultural policies has 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 adopt the EU’s Common Agricultural Policy.

82. **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 result of the model’s simulations are summarized below:

- **2003 reform.** 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 under the 2003 reform regime.** Elimination of restrictions and reductions in duties on agricultural goods will generally lead to a decrease in agricultural prices leading to an overall average 4 percent decrease in food prices. Lower prices 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 2003 regime of direct payments in Croatia will lead to a projected 2.5 percent increase in farmers' incomes; agricultural production will rise 6 percent over the long term.

- **Adoption of the CAP.** EU-like agricultural reforms would probably have a mixed impact on incomes in Croatia. While the new policies would negatively impact farmers' income, the population as a whole would be better off due to lower food prices on average compared to the current situation. Specifically, compared to the 2003 regime, 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 about 0.6 percent to 0.8 percent of GDP as a result of the reduction in agricultural support.

83. **While the model shows that the adoption of CAP policies would represent a welfare improvement with respect to the current regime, these policies would still fall short of achieving the economic gains associated with a system based on lump-sum payments and no price distortions.**¹⁵ Compared to a non-intervention scenario, the levels of support implied by Agenda 2000 policies still yield a higher farmers' income (excluding direct payments) and a bigger overall loss for consumers due to higher food prices than under a "laissez faire" scenario. *The implication is that, rather than adopting CAP-levels of intervention in the interim period, Croatia should consider moving toward a non-intervention scenario and possibly compensating farmers directly.*

84. **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 nature of the instruments and requirements of the CAP as a "moving target." The latter will need to be adjusted to reflect, among others, the results of the Doha Round of multilateral trade negotiations.

85. **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:

- **Settling remaining land ownership issues and creating 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.
- **Accelerating the privatization and restructuring of remaining AKs and other large farming structures.** Its role should be limited to dividing

¹⁵ This happens both under CAP Agenda 2000 policies and CAP Mid-Term Review policies. However, welfare losses (vis-à-vis no intervention) are smaller under the CAP Mid-Term Review.

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.

- **Allow unprofitable farms to disappear and free the resources for profitable and efficient operations.** This can only be achieved by adopting hard-budget constraints and effectively implementing the ultimate threat of bankruptcy for non-performers, regardless of farm type.

86. **The second part of the strategy entails the adoption of the same policy instruments as used 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. The following adjustment would need to be considered:

- **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. Interventions ought to be based on the observed evolution of market prices (rather than production forecasts) and price support would need to be transferred to the wholesale level instead of the farm gate for most products.
- **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.
- **Taxation system and the tax concessions provided need to be harmonized with the EU practices and requirements.** All tax preferences for farmers, in particular, would have to be eliminated.

87. **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 *acquis 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 will the alignment of legislation 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 CAP, 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 difficulties experienced by candidate countries suggests that this task should be given high priority).
- The introduction of the Integrated Administration and Control System (IACS) also constitutes a critical prerequisite for the functioning of the CAP.

- Establishment of an Agency or Department for Rural Development would facilitate the implementation of a coherent rural development strategy.
- A unified veterinary and food control authority in line with EU policy would eliminate overlapping and improve efficiency.
- A central agency would need to be established to manage plant protection and adopting EU phytosanitary standards.
- The creation of a farmers association (based on voluntary membership) needs to be promoted.

Financial Markets

88. **Successful adjustment to increased competitive pressures from trade liberalization will require an efficient financial sector, which can mobilize resources towards expanding firms/sectors.** Otherwise, job destruction will not be followed by job creation. Croatia's financial sector should play a central role in the process of enterprise restructuring and investment. The efficient intermediation of savings fulfills, as well, the important social role of promoting domestic financial savings crucial to reducing vulnerability to external capital volatility and assigning resources to its best possible use.

89. **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. In the non-banking sector, there had also been progress in development of the capital markets and the introduction of a new pension system that should provide strong demand for both debt equity products over the long term.

90. **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. The very severe problems in the operation of the Croatian legal system pose an obstacle to prudent lending 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.

91. **The banks, over time, will face an increasingly difficult choice driven by the pressure of their liquidity.** This choice will be between competition-driven pursuits 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.

92. **Bank supervision should carefully monitor fast-growing banks.** The very fast growth in lending by some banks, driven by liquidity and competitive pressures, is

grounds for some supervisory concern, particularly given the 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. CNB should intensively monitor and test portfolios to ensure that risks are being fully recognized and provisioned and that there is an opportunity for early supervisory intervention where required.

93. **The CNB recently adopted new regulations in recognition that very fast growth in lending by some banks has raised some supervisory concern, particularly given Croatia's poor creditor framework.** In January 2003, CNB introduced 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. A third policy measure introduced obliges banks whose risk assets grow more than 20 percent on an annual basis to build up their capital to buffer potential future losses. Unlike the other two policies, this one is a permanent modification. Together these measures represent a fairly strong financial penalty for aggressively growing banks.¹⁶

94. **The "euroization" of deposits, even if hedged by euro loans, may not suffice to inoculate banks against swings in the 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.

95. **Currency stability, however, cannot be taken for granted; hence, the need to tighten prudential regulations.** Such regulations could induce depositors, borrowers, and the banks to internalize the balance sheet, liquidity, and solvency risks associated with foreign exchange risk. For example, higher liquidity requirements may be imposed on foreign exchange deposits; such requirements may have to be invested in high quality foreign exchange instruments. Or foreign exchange loans could be limited to exporters or firms/individuals capable of generating true foreign exchange revenues.

96. **The bank bankruptcy and voluntary liquidation of banks governed by the bankruptcy law and the banking law have weaknesses that reduce the efficiency of**

¹⁶ 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 that 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 gradually. 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 exit process and drive up the costs of bank exit to the State (in the role of deposit insurer). 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.¹⁷
- Give the creditor's committee the power to appoint and remove the bankruptcy manager and directly supervise his activities. This would give creditors greater control over the liquidation process, allow the appointment of qualified managers, and increase the transparency of the process.

97. **The CNB is engaged in an ongoing dialogue with the EU regarding compliance with specific directives.** The new Banking Law further aligns Croatian legislation with the Community *acquis* on banking. The new Banking Law has removed obstacles to communication with EU bank supervisors previously posed by bank secrecy requirements.

98. **However, while negotiations are ongoing, the CNB presently still needs to sign 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. *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 that could be an impediment to consolidated supervision.*

99. **Croatian capital markets are still very much at the developmental stage.** This is reflected in lack of financial and human resources available to the Croatian Securities and Exchange Commission (CROSEC) to perform its work. Many of the reforms proposed above to strengthen corporate governance, disclosure, and protect minority shareholders would be conducive to the development of capital markets. Similarly, opportunities arising from the privatization of SOEs should be seized to force listing of these companies through public offerings of minority stakes.

100. **The introduction of pension system reforms in 2002 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.** 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.

¹⁷ If this provision were 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.

101. **The insurance industry is relatively small and undeveloped. This sector, like the rest of the financial sector, suffers from problems posed by the inadequacies of the legal system, reinforcing the point that reform is urgent in this area.** Aside from the legal system, two priorities for action by the authorities can be identified (a) *an expert assessment of the institutional capacity of the Directorate* in charge would be appropriate to determine whether or not it is providing adequate supervision for the industry; and (b) *completion of drafting and passage of an EU-compliant insurance law*. By the end of 2002, the industry will be dominated by firms of EU origin. It is important that these firms operate within an identical regulatory framework to that in the EU and that domestic firms are required to meet EU standards: this will both level the playing field for competitive purposes and have the beneficial effect of requiring domestic firms to upgrade their operations and risk management to meet EU standards.

Strategy for Education and R&D

102. **Croatia's education and training system and its research base is a key factor of the business and investment climate and of Croatia's aspirations for European integration.** 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 is heavily reliant on the efficient working of good and factor markets and on the consolidation of the investment-driven phase. However, as Croatia advances in the process of European integration, it has to take actions that stimulate innovation-based growth.*

103. **Innovation-driven growth requires 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. Employers have to restructure work; workers need different skills; and education, training, and knowledge production systems have to be restructured to meet evolving employer and employee needs. Characteristics of knowledge-based growth economies are: knowledge-based jobs steadily increase as a share of total jobs; returns to higher education increase, while returns to secondary education decline (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. Overall, workers are confronted with the need for continuous retraining.

104. **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). They need the

executive thinking or “knowing how to learn” skills that give them the ability to mobilize and monitor alternative strategies for solving unfamiliar problems. They need to be able to function in teams that are often socially heterogeneous. 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.

105. Against this background, Croatia’s educational system does not score well on various grounds:

- 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.
- Although Croatia has a high share of students that have completed some form of secondary school, 58 versus 43 percent in the OECD, 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, 55 percent versus only 9 percent for the OECD. Against this standard, only 37 percent of Croatia’s working age population versus 61 percent for the OECD might be expected to have acquired the competencies required by a modern workplace.
- Finally, 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.

106. 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:

- **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 needs to be revised to support more project-oriented learning, and develop the higher order (critical thinking, problem solving) cognitive skills and executive cognitive 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.
- **Pedagogy.** Curriculum and pedagogy 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. Its success

depends on what teachers do and think. To be successful, reform has to respect the world confronted by those asked to change.

- **Accountability.** Build accountability for results around interpretable international and national assessments of learning. The Government has taken an important step to benchmark the learning outcomes of Croatian students against those of their EU counterparts by deciding to participate in PISA.¹⁸

107. **The other pillar of innovation-driven growth, the R&D system, has been micro-managed by the State despite the fact that this is the sector that most needs to be nimble, flexible, and entrepreneurial.** The Scientific Research Activities Law of 1993 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 Ministry of Science and Technology (MoST). 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.

108. **As of 1996-97, Croatia had about half the number of fulltime researchers per million population as the average for the OECD countries.** In 1997-2000, it had about 60 percent of the fulltime researchers per thousand economically active individuals as the EU countries. Research productivity, as measured by published articles in chemistry only, is less than EU and most East European countries.

109. **To address the above difficulties and create better conditions for innovation-driven growth, the central government should shift to a demand-driven system of education, training, and research, and to decentralized control combined with accountability for results that should be monitored by the center.** The 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. 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.

110. **Croatia should structure its tertiary education system flexibly to let institutions, faculties, students, and supplier markets 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. The 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.

111. **The State should focus its direct R&D investments on basic research.** 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

¹⁸ Program for International Student Assessment. Thirty two countries participated in the first PISA round.

general domain of knowledge, a company cannot monopolize the returns on its investment.

112. **The State needs to create a positive institutional environment for companies to invest in R&D.** A competent evaluation of corporate impediments to investing in R&D is needed. The evaluation should identify actions that can create a positive institutional environment, 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.

113. **The Government could also consider granting incentives for high quality, entrepreneurial R&D.** For example, increasing the production of young scientists is instrumental to meeting the R&D objectives. Research institutes could become a training base for university graduate students. 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. 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.

114. **Many of these issues will soon be addressed when a draft Law on Science and Higher Education, which has recently submitted to Parliament, is adopted.** The draft law 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; and underdeveloped quality control of higher education institutions and programs. 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.¹⁹ The EU is supporting these reform efforts through 16 projects within the TEMPUS program and three CARDS projects.

Infrastructure

115. **Infrastructure development is an integral part of Croatia's European integration strategy.** In line with EU directives, Croatia has recently moved rapidly to prompt the private sector to play a critical role in the modernization of the energy and transport sectors. It constitutes not just an excellent opportunity for private investors; it will also contribute to improve the quality and reduce the cost of key infrastructure services, thus strengthening the supply side of the economy. In view of the large investment needs, shifting responsibilities to the private sector is also a necessity for sustaining Croatia's medium-term fiscal plans.

¹⁹ The European Credit Transfer System is already being piloted in some institutions of higher education.

116. **Academic evidence and the experience of many countries (including from the EU) suggest that the use of market mechanisms will, in many cases, be the most conducive for the development of efficient energy and transport sectors.** In that regard, the SAA has provisions for both the energy and transport sectors, aimed at modernizing Croatia's infrastructure and harmonizing the regulatory framework with that of the EU. For example, Article 101 of the SAA states that cooperation will reflect the principles of the market economy and the European Energy Charter Treaty,²⁰ and will develop with a view to the gradual integration of Europe's energy markets. Similarly, the development of an efficient transport sector through the use of market mechanisms is a principle that guides much of the *acquis* in relation to transport policy.

117. **Since the end of hostilities, Croatia has moved a long way towards developing a transport sector along these lines; it has also passed the main laws that would facilitate private sector participation in the energy sector.** For instance, through the liberalization of the road haulage sector, or the (ongoing) restructuring of Hrvatske Zeljeznice (HZ, or Croatian Railways). However, there remains much to be done to achieve the mutually reinforcing targets of integration into European infrastructure networks and establishing a transport sector based on market principles. 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.

Energy Sector

118. **Croatia's energy sector currently remains currently dominated by state-owned companies.** Hrvatska Elektroprivreda d.d. (HEP) is a state-owned public enterprise that currently carries out the activities of generation, transmission and distribution of electricity; as well as operation of the national power system. The company has a virtual monopoly, supplying about 95 percent of the total electricity requirements in Croatia. The Law on privatization of HEP, adopted in March 2002, established the framework for partial privatization of HEP

119. **The recent 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* will be responsible for operating and controlling the electricity system; ensuring access to third parties on the basis of regulated tariffs; and balancing supply and demand for electricity with respect to contracted quantities.

120. **Similarly, the vertically integrated state-owned company INA has dominated Croatia's oil and gas industry.** The principal activities of INA and its subsidiaries

²⁰ Energy Charter Treaty (1994).

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. Around two-thirds of the country's crude oil consumption comes from overseas fields operated by INA.

121. The INA Group has undergone some restructuring since the Government announced its initial privatization plans in 2000. Binding offers for 25 percent plus one share of INA were received from three international bidders in January 2003. A decision on the bids was expected by July, 2003. 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.

122. Current developments in the sector have been initiated by the Law on the Gas Market and the Law on Oil and Oil Derivatives Market, which were both adopted in 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.

123. Croatia has deregulated fuel oil prices, and partially deregulated gasoline, diesel, gas oil, and heating oil prices. From January 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, 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 are expected in order to move towards cost-reflective tariffs and enable investment, notably expansion of the gas network.*

124. 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.

125. The development of electricity generation and the transmission system should take into account the interconnected nature of the region's electricity grids. This is at the core of the energy strategy for South-East Europe outlined in the Athens Memorandum of Understanding 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. 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. Preliminary work by the Commission suggests that if appropriate measures are taken, no new power production capacity will be required in the short and medium term.

126. The Commission set differentiated objectives for the oil and gas networks for which 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 up 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. The focus should be on expansion of networks aimed at diversifying the supply sources, and thus increasing competition and the security of supply.

127. With the passage of the energy law package, Croatia has taken an important step to meet the requirements of the SAA and other requirements emanating from the Athens Memorandum of Understanding. 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. The following key factors should be considered for developing a successful framework for energy reform:

- **Energy networks should be capable of supporting competition, or else constraints on entry in the electricity and gas markets will arise.** 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.
- **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. *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.*

- **The independent regulator for the electricity and gas markets (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. 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 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. This would allow CERC to build up their expertise on energy regulation.

Transport Sector

128. **The development of an efficient transport sector is a vital prerequisite for the development of a flourishing market economy, particularly for a small country strategically located next to the EU and committed to intensify regional and international trade links.** Aligning Croatia's legal and institutional framework with the EU *acquis* in the transport sector will be conducive to increased efficiency and overall competitiveness, largely through the greater liberalization of the sector. A growing role for the private sector in transport will help to simultaneously expand the network and reduce transport costs with obvious benefits for the process of regional and European integration.

129. **The supply of transport infrastructure in most modes has increased in the last decade.** Partially due to the U-shaped geography of Croatia, the supply of transport infrastructure is extensive relative to similarly sized countries in South-East Europe. In terms of roads, the most significant figure is perhaps the increase in the kilometers of motorways by over a third since 1995. As motorways are expanding more rapidly, the overall increase in the size of the road network (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 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. 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, by one-third since 1991, are inland water and maritime navigation.

130. **The transport sector absorbs a large share of public expenditures, about US\$1 billion or 6 percent of GDP.** This is very high by international standards; in the U.K. and France, the equivalent figure is approximately 1.5 percent. At the same time, the much higher proportion of public expenditure devoted to the sector leads to only a marginally higher contribution to GDP. *This would strongly suggest that such a high proportion of public expenditure would be inefficient.* There are some worrying signs that

the most inefficient forms of this spending may be steady or even increasing (e.g., operating subsidies increased between 1999 and 2001).

131. **Croatia intends to undertake in the next five years an ambitious €4.8 billion transport investment program. It is unclear how well such investment relates to European integration and SAA requirements.** While it would be desirable to apply TINA²¹ methodologies to all of the prospective investment plans, at the very least it should be applied as a matter of urgency towards 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 reduction in the road program, particularly the €1.6 billion highway program.* In fact there is some evidence that investments in motorways is crowding out road maintenance. Due to a significant maintenance backlog, the present state of the network is well below an appropriate standard.

132. **The Government should evaluate present levels of maintenance expenditure to determine the economic benefits that will result from additional spending.** The Government should also consider the introduction of some form of incentive scheme for Hrvatske Ceste (HC), a state-owned joint-stock company responsible for the management of all state roads except motorways, such that it is financially rewarded or punished depending on its performance in maintaining the road network.

133. **Croatia has made significant progress towards establishing a transport sector based on market principles and fair competition.** For example, 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.

134. **The EU advocates that charges for infrastructure should reflect the marginal social cost of use.** Users should be charged 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.

135. **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.

²¹ 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.

Nevertheless, there are some changes to the present structure of its road-charging policy that Croatia could consider: 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. 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.

136. The issues concerning the rail sector relate to two main areas: the provision of infrastructure and the restructuring of the sector. 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 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.

137. 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 reform that the Croatian rail industry needs to undertake in order to facilitate and/or promote competition between different operators.

138. HZ has undertaken a number of reforms to improve its operating efficiency. Following a number of reforms implemented in the 1990’s productivity within the company increased, the number of traffic units on the network increased, and state operating budget subsidies were eventually reduced. Ongoing plans for company restructuring include the preparation for the separation of investment maintenance and building of infrastructure, maintenance and cleaning of administrative buildings. Despite recent improvements, productivity levels still remain at 50 percent of the 1989 level and HZ still remains overwhelmingly dependent on state budget subsidies. The Government’s operating subsidy of 45.4 percent is high by international standards. This level of subsidy is equivalent to an operating ratio 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 likely improve operating efficiency and harden remaining soft budget constraints. One significant step along this route which should be considered would 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

139. **The focus of EU rail directives is to facilitate liberalization of the European network, especially for freight operators, by ensuring that all railway undertakings are dealt with 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. HZ has also split its infrastructure from operations. Further changes would be needed some of which should be incorporated into the new Railway Traffic Act such as meeting the main requirements of the “First Railways Package” of the EU. This would require, *inter alia*, the establishment of an independent and powerful regulator.

140. **In terms of allowing fair competition and establishing a transport sector based on market principles in the remaining subsectors, it will be necessary that:**

- Competition in *air transport* would be improved by the ending of subsidies to Croatia Air and, potentially its privatization, following the successful model developed by the Czech airline;
- 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;
- In terms of *inter-modal competition*, Croatia should strive towards the principle of marginal social cost pricing. 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.

141. **In terms of social, technical, and environmental compliance, Croatia’s recent program of legislative change has brought the country more closely in line with the EU *acquis*.** In terms of road transport, social and technical standards appear to be broadly consistent although there remain some areas of discrepancy (axle loads, and, potentially, provisions relating to driving license conditions). In terms of environmental legislation, 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.

F. MANAGING CHANGE IN THE ENVIRONMENT SECTOR

142. **Croatia’s European integration and growth strategy is also associated with an improvement of its environmental standards.** 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.

143. **The environmental challenges facing Croatia are moderate when one looks at the physical environment.** Compared to the countries of Central Europe, Croatia is

relatively well off. Although there are some areas where urgent action is needed, 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.

144. **Still, 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 strategy aimed at meeting EU standards 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.²²

145. **In 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 1.2 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 that in critical periods cannot satisfy the needs for water in adequate quantities.

146. **In view of the importance of clean coastal water for the valuable tourism industry, wastewater treatment is being expanded to meet EU norms.** 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. 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 for this purpose it may benefit from substantial external assistance.

147. **EU directives also emphasize the importance of integral water management.** In Croatia, this will require strengthening the institutional set-up and human resources, defining the mechanisms for trans-border cooperation, defining the planning documentation and economic analysis criteria to support the plans.

148. **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

²² It should be noted, however, that if in an accession process there is a conflict between the National Environmental Action Plan (NEAP) and the *acquis*, EU priorities will take precedence over national priorities.

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. 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. Financing alternatives include increased use of charges to cover the costs of many of the services that will have to be introduced.

149. 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. Currently, Croatia meets the targets set under the Sulfur Protocol and the Multi-Pollutant Protocol to reduce emissions of SO₂ by 61 percent with respect to its 1990 level and to keep NO_x emissions at the 1990 level. *From an international point of view, the most problematic issues are those related to greenhouse gas emissions.* The issue here is that action is needed if Croatia is to meet its international obligations with respect to the Kyoto Protocol. To meet the targets, Croatia may introduce a CO₂ emission charge and/or use Kyoto flexibility mechanisms. The Government needs to prepare a strategy for meeting this target.

150. All in all, Croatia will need to invest considerably more than it normally does in environmental protection if it is to meet EU standards. *Staff estimates indicate that Croatia will have to invest an additional 5 to 10 billion euros over a 20-year period if it is to meet the acquis.* 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 as well.* Estimates indicate that these will be of the order of €80-120 *per annum per capita.* 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.*

151. The wide range is indicative of two things: uncertainty about unit costs and, more significantly, the relative cost effectiveness of the different investment strategies. Below three scenarios are presented, giving the private and public investments as a function of the policies implemented in Croatia.²³ 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.

152. Higher cost recovery in 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 and simultaneously helping to recover costs. For example, in the high reform scenario, pricing of utilities' services lead to full cost recovery. Likewise, the use of market-based instruments such as a CO₂ emission charge; hazardous waste

²³ The investments needed to comply with the *acquis* are not sensitive to the assumed short to medium-term growth rates in Croatia, as most of the expenditure is required to upgrade environmental protection for the current GDP. Of course, the greater the rate of reform the higher the expected economic growth will be, making the investments a smaller percentage of total GDP.

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. It is assumed that under medium and high reform scenarios existing charges are increased and under the high scenario new instruments are introduced.

153. **The other reforms that are critical to keeping public sector investments down are those that enhance the role of the private sector in the delivery of the services.** Under the base scenario the role of the private sector in investments will remain small, 10 percent in the case of the water sector. This goes up to 21 percent in the medium scenario and to 30 percent in the high scenario. In waste management, the shares of the private sector in investments are 25 percent, 43 percent and 60 percent under the base, medium and high scenarios. In the energy sector, private sector participation goes from 50 percent in the base scenario to 100 percent in the medium and high scenarios. The strengthening of institutional and human resources in the relevant public sector offices (including regulatory agencies) is a key condition for the successful involvement of the private sector.

154. **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. Several studies 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 wastewater treatment standards.

155. **An example where a longer phasing of investment efforts would be justified is the case of 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.*

156. **Even with the lower levels of state spending, however, the level required in the first few years would be more than double current state spending on the environment.** Although higher levels of environmental investment requirements are small relative to the overall public sector budget, it will need a substantial increase in environmental budgets. This has to be planned for including in terms of the institutional strengthening that will be needed in the Ministry of Environment.

157. **The Government proposes the establishment of the Environmental Protection and Energy Efficiency Fund to help fund integration costs in the area of the environment.** *The case is weak for special earmarked funds to finance environmental investments, however.* 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 while the new environmental standards are being mainstreamed.

G. CONCLUSION

158. **To sum up, the SAA process not only opens for Croatia the prospect of ultimate EU membership, it also offers it, in the meantime, a unique opportunity for growth through European integration.** Much of the growth impact will come not so much from the country's access to EU markets (which to a large extent predates the SAA), but from the improved investment climate that would result from aligning Croatian policies and institutions with EU best practices. This will facilitate the development of low-cost high-quality integrated infrastructure, harmonization of financial regulatory frameworks, modern social institutions, and more generally private sector development driven by the strengthening of competition from broad-based trade liberalization.

159. **The consolidation of a favorable investment climate in Croatia would require as well addressing the following critical bottlenecks:**

- **Faster fiscal reforms** to ensure debt sustainability even under low growth scenarios.
- **Decisive progress in land registry reform and in streamlining of bankruptcy procedures** to improve property/creditor rights.
- **Increased effectiveness of the judiciary through common practices, case management and administration systems.**
- **Enhanced labor market flexibility, strengthening of corporate governance and hard budget constraints**, including as regards the issuance of guarantees.
- **Genuine public administration reform**, to ensure effective implementation of the SAA so that the full benefits of the adoption and implementation of the *acquis* could be realized in terms of economic growth and sustained increases in the standard of living of Croatia's population.

160. **While Croatia is already making significant progress in most of these fronts, it is important to prioritize and sequence the reform agenda.** Some lengthy but strategically important reforms (e.g., fiscal and public administration) need to start right away. Others, probably more urgent, can be addressed quickly at low cost. These are for instance those reforms linked to improved property and creditor rights, rule of law, hard budget constraints, labor market rigidities. A number of reforms underway can be consolidated over the medium term - trade liberalization, financial reforms, education reform, and infrastructure deregulation. While the Report 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 more careful phase-in is

proposed. In the case of agriculture, the recommendation is to align agricultural support institutions with CAP requirements right away, but to bring down intervention levels below current CAP levels. Similarly, in the field of environment, it is advised to move fast on building up EU-conforming institutions while sequencing the investments needed to upgrade Croatia to EU standards based on benefits-cost ratios and, necessarily, on the availability of resources.

Kathryn Rivera
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