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Chapter 8

FREE MOVEMENT OF CAPITAL, THE REAL ESTATE MARKET AND TOURISM: A BLESSING OR A CURSE FOR CROATIA ON ITS WAY TO THE EUROPEAN UNION?

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ABSTRACT

This paper investigates how one particular aspect of the freedom of movement of capital – the right of EU residents to acquire real estate in EU member states – might shape Croatia’s EU accession negotiations and affect its real estate market, the tourism industry and the national economy. It identifies potential benefits and risks of unrestricted foreign investment in Croatian real estate, and attendant dilemmas for economic policies. The main conclusion is that Croatia stands to benefit in the long run from foreign investment in the property sector. However, a gradual approach to the opening-up of the real estate market to non-residents can be justified on a number of grounds. These include inadequate legislation limiting property speculation; potential spillovers of price increases from the market for secondary residences

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onto the local housing market (of which there is already some evidence); costs of the adjustment in the housing market and construction industry to a sudden large increase in demand for secondary residences; loss of competitiveness in the tourism industry if there should be violations of building regulations and the resulting overdevelopment of coastal areas; and macroeconomic pressures arising from large and sudden capital inflows.

Key words:

Croatian economy, European Union accession negotiations, new member states, free movement of capital, real estate market, housing prices, housing finance, secondary residences, travel and tourism, protection of public coastal domains, local government, capital inflows

INTRODUCTION

Since Croatia became an official EU candidate in June 2004, public discussions on the benefits and costs of accession have intensified in many areas. This paper addresses four issues that have attracted particular attention: How quickly should EU residents get unrestricted access to Croatia's property market? How will this affect – or is this already affecting – the local housing market? What will be the impact on Croatia's tourism? And what are the likely macroeconomic effects of foreign investment inflows into Croatia's real estate? As is often the case, serious research has yet to catch up with the enormous public interest in these issues. This paper is therefore a first attempt to analyse the issues in a systematic manner and provide guidance for future work in this area. The main purpose is to stimulate analysis and policy thinking on these important issues ahead of the upcoming accession negotiations with the EU.

Section 2 analyses Croatia's obligations under Chapter 4 of the *acquis*, Freedom of movement of capital, paying particular attention to the right of EU residents to invest in real estate in candidate countries, and discusses Croatia's current regime for property sales to foreigners. The current regime is rather restrictive, non-transparent and cumbersome in some respects, but relatively liberal in others. However, a more important issue is that this regime will eventually have to be abandoned, thus exposing the economy to potentially large-scale foreign property investments. For under EU law, EU citizens have unrestricted

rights to buy as much property as they like in any EU country without any need to reside in that country. This means that non-residents will not be restricted to buying only secondary residences as at present, but will also be able to buy property for speculative purposes, against which there is currently only weak protection in the Croatian legislation. Against this background, Section 2 investigates how Croatia can improve its negotiating position on this issue. Drawing on the experience of Denmark and Malta, the section highlights the importance of the expertise and negotiating skills of officials engaged in accession talks with the EU. It notes, however, the difficulty of articulating the view that EU residents should not be allowed to acquire property in Croatia for an extended period of time, and the importance of strengthening legislation to protect against property speculation.

Section 3 analyses potential implications of foreign investment in real estate for the local housing market. It discusses the main characteristics of Croatia's real estate market and reviews recent developments in housing prices. It finds some empirical evidence that increased demand for secondary residences by foreigners has led to an increase in prices of houses and land for construction on the Adriatic. It also analyses factors that might determine the effects of foreign property investment on the housing market in the future. These effects will depend on the speed with which the property market is liberalised; capacity constraints and competition in the construction industry; the speed with which legal impediments to property sales are removed; and developments in household incomes, housing finance and other factors influencing the affordability of housing. Given the likely supply rigidities, the section argues that a gradual approach to the opening of the real estate market to non-residents would allow for a more orderly adjustment than a rapid removal of restrictions.

Section 4 considers how increased foreign investment in real estate could influence Croatia's tourism industry. To provide insights into this question, the section analyses the size and main features of Croatia's tourism industry. The question that seems particularly relevant in this context is whether accession to the EU offers the opportunity for tourism to assume a leading role in overall economic development, or represents a threat to one of its main assets, the unspoilt coastal environment. On balance, Croatian tourism stands to benefit from foreign property investment. The key will be to avoid the risk of overdevelopment, that is, to ensure strict enforcement of existing building regulations and of the recently adopted legislation on the protection on the

public coastal domain. Greater foreign ownership of secondary residences could increase the attractiveness of the Adriatic coast and islands for other tourists and over the longer term perhaps contribute to the economic and demographic revival of many now dormant or abandoned communities.

Section 5 analyses diverse macroeconomic effects that increased foreign investment in real estate would have for the Croatian economy. The wealth effect has already been in evidence for some time, as the value of houses and land in areas that are attracting foreign buyers has increased considerably over the past few years. Due to potentially large capital inflows associated with non-resident real estate purchases, the section elaborates several arguments for a gradual opening-up of the market.

Section 6 summarises the main conclusions and elaborates a number of policy recommendations.

FREE MOVEMENT OF CAPITAL

The EU internal market is based on the principle of the “four freedoms” of movement: of goods, services, capital and people. As a general rule, the EU is not willing to accept candidate countries' requests to limit these freedoms because this could have a significant impact on competition and the functioning of the internal market. Croatia – as all EU candidates before it – will thus have to allow basically unrestricted movement of goods, services, capital and people by the time it accedes to the EU. The Treaty Establishing the European Community (Article 56) prohibits in particular all restrictions on movement of capital between member states but also between the member states and third countries, although certain restrictions in relation to countries outside the EU can be retained.

Freedom of movement of capital is defined in Chapter 4 of the *acquis communautaire*. It covers not only payments and transfers of money across borders, but also transfers of ownership of assets and liabilities (such as investments in companies and real estate or portfolio investments) and directives on prevention of money laundering. This paper discusses only one type of capital movement – the right of EU residents to purchase real estate in Croatia. Croatia's obligations in this regard are currently defined in the Stabilization and Association Agreement (SAA), (Article 60, point 2):

“As from the entry into force of this Agreement, Croatia shall authorise, by making full and expedient use of its existing procedures, the acquisition of real estate in Croatia by nationals of Member States of the European Union, except for areas and matters listed in Annex VII.ⁱ Within four years from the entry into force of this Agreement, Croatia shall progressively adjust its legislation concerning the acquisition of real estate in Croatia by nationals of the Member States of the European Union to ensure the same treatment as compared to Croatian nationals. At the end of the fourth year after the entry into force of this Agreement, the Stabilisation and Association Council shall examine the modalities for extending these rights to the areas and matters listed in Annex VII.”

By the time Croatia joins the EU, the SAA will be superseded by an Accession Treaty. Although the Treaty will be largely based on the SAA, it may treat a number of issues differently. The whole purpose of accession negotiations is precisely to agree under what conditions Croatia will accept, apply and administratively and legally implement different chapters of the *acquis*. Commitments under the SAA regarding non-residents’ right to purchase property in Croatia thus can and, as argued in this paper, probably should be re-negotiated in the process of Croatia’s accession to the EU.

What is the current situation regarding the acquisition of real estate in Croatia by non-residents? Private non-resident individuals can already become owners of real estate in Croatia (other than by inheritance) after obtaining permission from the Ministry of Foreign Affairs. They are restricted to one property, which is limited in size (the construction site cannot exceed 1,500 m²), and there are areas in which they may not acquire property, such as protected natural areas, agricultural land, forests and forest land and certain excluded areas.ⁱⁱ Key issues in the application procedure, which can reportedly take up to a year, are the approval of the transaction by the Ministry of Justice and the existence of a reciprocity agreement on real estate purchases between Croatia and a given non-resident’s home country.ⁱⁱⁱ For instance, US residents may be granted permission to buy property in Croatia because Croatian citizens can acquire property in the United States without restriction. In contrast, private individuals from Slovenia cannot acquire property in Croatia because Slovenia and Croatia do not have a reciprocity agreement in this area.^{iv}

According to the official data quoted by the news media, 3,200 foreign residents have obtained permission to buy real estate in Croatia

since 1996, when the property market was first opened to foreigners (Table 1).^v Less than 40% of applications have since been approved, 7% have been rejected, and over half have not yet been processed.^{vi} The number of applications has varied from around 550 per year during 1996-99, to around 1,250 per year since 2000.

In addition to private non-resident individuals, non-residents who set up a Croatian company can also acquire property in Croatia. In this case there is no need for government permission to buy the property (although there are various other legal and financial considerations) and the buyer is not restricted to one piece of property. There is no official information on the number of companies set up for this purpose. However, since establishing a company normally takes much less than one year and is not costly, there are indications that many foreigners (in particular from countries such as Slovenia that do not have reciprocity agreements) make use of this alternative to acquire real estate in Croatia.^{vii}

Table 1 Non-resident applications to buy real estate in Croatia, 1996–2004

	No. of applications	Approved	Not approved	In process
2004 (Jan-Sep) ¹	1,050	22	10	1,018
2000–04	6,257	2,381	445	3,431
1996–99	2,192	921	128	1,143
Total 1996–2004	8,449	3,202	573	4,574
Percent of total, 1996–2004	–	38.1	7.1	54.8

¹ *New applications only. In addition, 242 applications from previous years were approved and 46 rejected in the first nine months of 2004.*

Sources: Ministry of Foreign Affairs, quoted in Jutarnji list (21 October 2004) and Vjesnik (26 October 2004); author's calculations

The existing regime for property sales to foreigners can thus be characterised as relatively restrictive, non-transparent and cumbersome in some respects, but relatively liberal in others. In particular, it is not clear why the processing of applications takes so long and why the criteria used in evaluating the applications are not transparent and public. On the other hand, it is important to recognise that current arrangements with respect to the sale of property to third country residents are already more liberal than the EU legislation requires: not just EU nationals, but residents of any country where Croatian citizens have the right to acquire property can in principle become owners of real estate in Croatia. Moreover, residents of virtually any country can buy property if they register a Croatian company.

How will these arrangements change with implementation of the SAA and Croatia's accession to the EU? The main change is that, upon expiration of the four-year transitional period agreed in the SAA (or perhaps a longer period yet to be negotiated during accession talks), EU residents will have the right to buy real estate in Croatia without any restriction. This means that they will not be restricted to buying only secondary residences or just one piece of property, and will not be subject to other conditions, such as prior approval, size, or use of the property. Under EU law, EU citizens have full rights to buy as much property as they like in any EU country without any need to reside in that country. This means that non-residents can also buy property for speculative purposes, unless this is limited by domestic legislation, which is largely not the case in Croatia at present.

It is not clear whether these implications of EU accession are clear to the Croatian public and to policy makers. In any case, they have not yet been articulated in public discussion. The real issue is that the existing restrictions on real estate sales to foreigners, however imperfect, will eventually have to be lifted, thus exposing the economy to foreign property investments of potentially far greater magnitude than anything that has been observed so far. This raises the question of whether the authorities could or should do something to keep the existing restrictions in place for more than four years, and how to better protect in the meantime against property speculation.^{viii}

At present, commercially motivated property sales in the secondary market are subject to income tax only if the sale occurs within three years from the purchase of the property. Part of the capital gains from such sales is not taxed.^{ix} There seem to be no additional regulations preventing speculation in the market for land or uncompleted property. For instance, an entrepreneur could buy up large swathes of land for construction, or batches of uncompleted apartments and houses, in the expectation that prices will rise rapidly due to limited supply, and then resell at a higher price. While the entrepreneur would pay the regular profits tax, the tax authorities would not be in a position, as in most mature market economies, to make a judgement about the fair value of such transactions, and, hence, any extra profits earned by the entrepreneur due to speculative activity. The lack of capital largely prevents Croatian citizens from engaging in such activities at the moment, so the weakness of anti-speculative regulations may not be obvious. But once the property market is opened up to non-residents, the lack of capital will no longer con-

strain this type of activities, and the weakness of the legislation could manifest itself very quickly, resulting in the meantime in potentially large disruptions in local property markets. The remainder of this section considers only the first issue – whether the authorities could or should do something to keep in place the existing restrictions on property sales to non-residents. The issue of anti-speculative legislation requires a separate expert analysis that goes beyond the scope of the present paper.

How have other candidate countries handled the issue of transitional periods for real estate purchases in their accession negotiations? The biggest issue in most cases turned out to be the right to purchase land. Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia requested 10-18 year moratoria on the sales of land to EU residents (Table 2). They justified the need for moratoria by several social and economic factors, including the high share of the population working in agriculture; underdeveloped land markets; significantly lower land prices in candidate countries than in the EU-15; and substantially lower average income of domestic population relative to EU nationals, which would give EU nationals an unfair advantage in purchasing agricultural land in new member states.^x

Recognising the high political sensitivity of this issue, the European Commission proposed in May 2001 that the candidate countries should be allowed to limit the acquisition of agricultural land by other EU nationals during a transitional period of seven years after their accession to the EU (European Commission, 2001a).^{xi} During this period, the candidate countries would have to use objective, stable, transparent and public criteria for the authorisation procedures for land acquisitions. The Commission also proposed a review, to take place after three years, to determine whether this transitional period could be shortened or even lifted.

The Commission's proposal was perceived as a trade-off on a broader issue of far greater importance to the EU-15, that is, between the demand of the EU-15 for 5-7 year transition periods for the free movement of workers from Central and Eastern Europe (CEE), and the candidates' demand for longer transition periods for land purchases by non-residents. Most candidate countries endorsed and eventually adopted the Commission's proposal (Table 2). The only exception was Poland, which insisted on a longer transition period fearing that foreign residents might buy relatively cheaply its abundant reserves of agricultural land. As Poland has by far the largest

population among the new member states and at the same time there were fears in some old members of the EU that Polish workers might crowd out domestic labour after the accession, the Polish authorities managed to negotiate a 12-year moratorium on land purchases by non-residents in exchange for a seven-year transition period for the free movement of Polish workers to most EU countries.^{xiii} Most countries also negotiated the possibility to extend the seven-year transitional period by another three years if a special safeguard clause is invoked.

The right of EU nationals to purchase secondary residences in candidate countries was considerably less controversial. Cyprus, the Czech Republic, Hungary and Slovakia requested five-year transitional periods, mostly citing concerns about the impact of large-scale real estate purchases by foreign residents on the prices and affordability of local housing. The Baltic countries, Bulgaria and Slovenia, allowed EU residents to purchase secondary residences even before their accession talks and therefore requested no transitional arrangements at all, although Slovenia negotiated the right to invoke a general economic safeguard clause to protect its real estate sector over a period of seven years. Against this background, it is interesting that some media reported a different interpretation of Slovenia's position, according to which Slovenia tried but did not manage to negotiate a transitional period for real estate purchases.^{xiii}

The European Commission's proposal for a five-year transitional period for secondary residences was eventually adopted by all new member states except Malta, which presented a special problem. Malta's case is instructive and deserves particular attention because of some similarities on this issue with the current situation in Croatia (see Box 1).

Another interesting example is Denmark. Foreigners are free to buy real estate in Denmark for business and primary residence purposes (subject to certain residency restrictions), but not as secondary homes. In particular, foreigners cannot own holiday homes along the Danish coast – such properties can only be rented out. This restriction dates back to the mid-1960s, when Denmark was not yet in the EU and there were fears that foreigners might buy holiday properties on the coast for speculative purposes. To prevent speculation, non-residents were not allowed to own vacation homes that are kept unoccupied most of the year. Upon accession in 1973, Denmark was allowed to keep this restriction.^{xiv}

Table 2 Candidate country positions on acquisition of real estate by European Union nationals¹

Country	Secondary residences		Agricultural and forestry land	
	Country's negotiating position	Transitional arrangement agreed with EU	Country's negotiating position	Transitional arrangement agreed with EU
Bulgaria	0 ²	5	10	7 ³
Cyprus	5	5	N ⁴	N ⁴
Czech Republic	5	5	10	7 ^{3,5}
Estonia	0 ²	0	0 ²	7 ^{3,5}
Hungary	5	5 ⁶	10	7 ^{3,5}
Latvia	0 ²	0	10	7 ^{3,5}
Lithuania	0 ²	0	0 ²	7 ^{3,5}
Malta	P ⁷	P ⁸	N ⁴	N ⁴
Poland	— ⁹	5	18	12
Romania	— ⁹	5	15 ¹⁰	7 ³
Slovakia	5	0	10	7 ^{3,5}
Slovenia	0 ²	S ¹¹	0 ⁶	S ¹¹

¹ Delay (years after accession to the EU) in the right of EU nationals to acquire secondary residences and agricultural and forestry land in candidate countries.

² No transitional periods or derogations requested.

³ Excluding self-employed farmers.

⁴ Cyprus and Malta were not required to liberalise land acquisition due to the very small size of agricultural and forestry land.

⁵ Possibility to extend transitional period by 3 years if the country invokes safeguard clause.

⁶ Excluding EU and EFTA residents residing in country for at least 4 years.

⁷ Permanent derogation of the acquisition of secondary residences by non-residents and of real estate for speculative purposes.

⁸ Permanent derogation: only EU nationals residing in Malta for at least 5 years can buy more than one property on the island.

⁹ No information on the negotiating position available.

¹⁰ In addition, five-year transition period for the liberalisation of land acquisition inside town limits.

¹¹ Special arrangement: possibility to resort to a general economic safeguard clause for 7 years in real estate.

Sources: Foreign ministries of new member states; European Commission (2001); Deutsche Bank Research (2000)

In summary, the cases of Malta and Denmark, along with the Polish extension of the period for agricultural land purchases by non-residents, illustrate that the scope for adopting solutions suiting the interests of candidate countries is not limited ex ante and depends, among other things, on the expertise and negotiating skills of public servants engaged in accession talks with the EU.^{xv} Nevertheless, one

should not underestimate the difficulty of negotiations on this point. The arguments for either the Maltese or the Danish exemption may not be easily applied to Croatia. Moreover, as discussed in the conclusion, no country can expect to benefit from the rights of membership if at the same time it does not want to shoulder the obligations. The challenge in this particular case will be, first, to identify an important national interest (if any) in postponing the liberalisation of the real estate market for non-residents; and second, to demonstrate that applying unrestricted rights of EU residents to acquire property in Croatia would go against this interest for an extended period of time. One obvious candidate for such an interest is the need to limit property speculation. Such a move would not go against the spirit of EU accession because other EU member countries have such legislation. The sections that follow elaborate several other economic arguments that tend to support the case for a more gradual approach to the liberalisation of the property market.

Box 1 How did Malta negotiate an exemption from the complete liberalisation of real estate sales to European Union residents?

As in Croatia, non-residents – including from non-EU countries – could acquire property in Malta even before the country’s accession to the EU. Restrictions on property sales were similar to those presently used in Croatia – the sale required prior approval, only one secondary residence of limited size could be acquired by non-residents, and the value of property had to be above a certain limit. The rationale for these restrictions was to retain a measure of control on land use and to prevent speculation. Foreigners could acquire additional property in Malta beyond the secondary residence only if they obtained Maltese nationality.

During accession talks, Malta requested to be able to keep these restrictions on a permanent basis. The authorities were in particular concerned that if EU residents had unrestricted access to the real estate in their small island country, this could lead to more widespread economic and social problems. They supported their case by several well-founded arguments.

First, they argued that, with population of 395,000 and territory of just 316 km² (by comparison, Croatian islands of Brač and Hvar have surface areas of 395 km² and 300 km², respectively), Malta was by far the most densely populated country in the EU-25. As a result, land available for construction could only cover the basic needs of the local population.

Second, they argued that, if the right of EU citizens to buy property in Malta after membership led to an increase in demand for property, this could affect property prices and have a negative social impact on Maltese families, especially on young couples. While housing affordability is not only affected by EU membership – the property prices have been rising in Malta for many years – Malta’s concern was that EU membership should not add to the problem by making housing even less affordable.

Third, they argued that concerns about housing affordability in their densely populated country were permanent because, should a problem arise, it would be greater in future than at present, affecting future generations more than the current ones. This is why a transitional period was not sufficient for Malta: only a permanent arrangement was acceptable.

The European Commission accepted these arguments and the EU eventually agreed that Malta may maintain, on a permanent but non-discriminatory basis, the existing restrictions on the right of EU citizens to acquire just one secondary residence in Malta. However, after residing in Malta for at least five years, EU citizens will be allowed to buy additional property beyond the secondary residence. The five-year residence requirement was the balance that was struck between the two diametrically opposed positions in Maltese and EU law. Under Maltese law, foreigners can never have full rights to buy property in Malta – that is, to buy property other than one secondary residence – unless they obtain Maltese nationality. On the other hand, under EU law, EU citizens have full rights to buy as much property as they like in any EU country without any need to reside in that country.

Source: Busuttill (2002)

IMPLICATIONS FOR CROATIA’S REAL ESTATE MARKET

To understand the broader economic implications of a more liberal regime for the acquisition of property by foreigners, it is necessary first to consider some basic features of the real estate market in Croatia. One should note from the outset that there is very little published research on the economics of the Croatian property market.^{xvi} Moreover, statistical data on the real estate market are very patchy.

Given the many transformations of this market (for instance, from state-owned, to company- and socially-owned, to privately-owned housing) and institutional differences with western European and former socialist countries, an empirical research programme on the economics of the real estate market would be extremely useful for researchers, policy makers and the real estate industry. This section can in no way fill this gap; it will only attempt to outline those features of the real estate market that might be relevant in the course of Croatia's EU accession.

The real estate market is usually one of the most closely watched sectors in mature market economies. It plays a crucial role not only because housing accounts for the bulk of the personal wealth, but also because of linkages with key investment, saving, and consumption choices of households and businesses. In addition, the real estate market affects competitiveness as a major input in the productive capacity, in particular in service oriented economies such as Croatia's, and as an important determinant of banking and equity market performance, both of which are highly affected by movements in property prices.

The real estate market in Croatia is still relatively small – construction and real estate industries account for around 13% of GDP, compared with 20-25% of GDP in many industrial countries, indicating considerable potential for future growth. The real estate market started to develop in earnest in the second half of the 1990s, after most of the housing and commercial property stock inherited from the socialist period had been privatised. Privatisation of housing led to an increase in the already high proportion of both privately-owned and owner-occupied housing. According to the 2001 Census, 96% of the 1.4 million permanently occupied dwellings in Croatia are owned by private individuals, and 83% are owner-occupied dwellings.^{xvii} For comparison, in western Europe the share of housing owned by private individuals ranges from about 60% in Austria and Sweden to 90-95% in Belgium, Greece, Spain and Portugal; while the share of owner-occupied housing ranges from 38% in Germany to 80% in Ireland (OECD, 2001).^{xviii} Croatia is in this respect similar to some other CEE countries, where privatisation has also resulted in a high level of owner-occupied housing.^{xix}

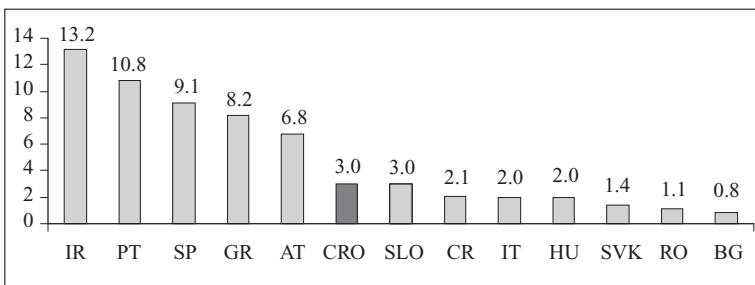
There is little reliable information about the state of the housing stock in Croatia. Comparing the total number of households (1.48 million) with the number of permanently occupied dwellings indicates a small deficit in the housing stock (about 56,000 dwellings in 2001).^{xx}

However, if one considers the additional stock of about 200,000 dwellings that are temporarily unoccupied, the number of dwellings exceeds the number of households by about 10%.^{xxi}

The picture on the regional distribution of the housing stock is also unclear. The Ministry of Environmental Protection, Physical Planning and Construction (MZOUP, 2003:35) argues that there is a significant shortage of housing in middle-sized and large cities, and at the same time a significant surplus of housing in small towns. Large differences in apartment prices between cities such as Zagreb and Karlovac would tend to support this view. However, Tica (2004) argues that if temporarily unoccupied dwellings are counted, all Croatian counties, including the city of Zagreb, have a surplus in the housing stock.

Regarding housing supply, defined here as the flow of new housing (the “primary” market) plus sales of existing homes (the “secondary” market), the available data suggest that supply in the primary market is relatively tight. During 1996-2001, about 13,600 dwellings were on average completed each year.^{xxii} To compare this figure with just one segment of the potential demand for housing, there were on average 70% more marriages (about 23,000) each year during this period. In international comparison, with an average of 3 newly completed dwellings per 1,000 inhabitants during 1996-2001, Croatia is near the bottom relative to western Europe, although it compares favourably with other central and eastern European countries (Figure 1).

Figure 1 Newly completed dwellings per 1,000 inhabitants



Data for Croatia: 1996-2001 average; for western European countries: 2000; for central and eastern Europe: 1998.

Sources: Central Bureau of Statistics (Croatia), OECD (2002), CIRIEC (2002).

Although there are no comprehensive data on sales in the secondary market, the available indicators suggest that the supply is constrained in this market as well. Perhaps the most important reason is that many properties – including many of those temporarily unoccupied – do not have clean titles, so many potential trades cannot be realised. As discussed below, this state of affairs is due to huge backlogs in the judiciary, the often chaotic state of property registers and deficiencies in urban planning and the enforcement of building relations.

Furthermore, much of the housing stock has been privatised to occupiers for nominal payments or at no cost. Privatisation thus resulted in windfall gains according to who happened to be living in a dwelling at the time. Many people therefore occupy dwellings that they would not otherwise be in a position to afford. Such properties are not likely to be offered for sale, which limits the effective supply.

The third reason is that standards of construction were often poor, resulting in problems with the quality of many existing dwellings. According to the 2001 Census, one-third of Croatia's housing stock is older than 45 years (i.e., constructed up to 1960); 60% was constructed between 1961 and 1990; and only 8% since 1991. From an investment point of view, the amortisation period for buildings is usually 50 years, so the bulk of the housing stock in Croatia is close to or past its useful life. This also means that privatisation has saddled many occupiers with liabilities in the form of high maintenance obligations.

Finally, as part of the economic transformation, the public sector has largely pulled out of the housing construction business, while private firms have not yet expanded sufficiently to bridge the gap in all segments of the market. In particular, the financial problems of the public sector have resulted in a sharp decline in the construction of social housing.

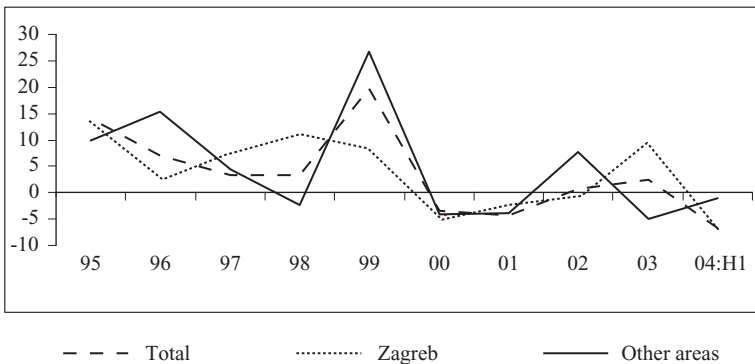
On the basis of these observations, one can form a working hypothesis that the supply of housing is presently tight in both primary and secondary markets. The question is, then, what is the likely impact of growing demand for vacation homes by foreigners on the residential property market? In particular, how realistic are fears, often expressed in the public, that rising prices of summer vacation homes along the Adriatic coast could spill over to the local housing market and negatively affect the affordability of housing for ordinary Croatian households?

The potentially most important channel for the transmission of price increases from the market for secondary residences to the residential housing market is the expectations channel. As with all assets, current prices of real estate depend on expectations of future prices. The housing market seems to be tight at the moment, so price increases in

the market for secondary residences are likely to be rapidly transmitted to other segments of the market. Most relevant in this context is the market situation on the Adriatic coast and islands, where most of the property sales to foreigners are taking place. The number of permanent dwellings on the coast and islands was 355,000 in 2001.^{xxiii} In addition, Croatians owned on the Adriatic about 118,000 vacation homes in 2001, which represented two-thirds of the total number of such homes in Croatia. Thus, vacation homes are already a key segment of the housing market on the Adriatic, accounting for a quarter of the total housing stock in this region. Moreover, domestic and international media indicate growing interest of foreigners in buying property on the Adriatic, including for investment purposes.^{xxiv} According to the news media, prices of houses and land for construction have risen by 20-30% over the past two years, and by 50-100% in most attractive locations such as the old city of Dubrovnik.^{xxv}

Given the relative size of this market segment and of reported price increases, it is conceivable that rising prices of summer vacation homes and of land for construction could, as postulated above, spill over to the housing market for local residents and affect house prices and affordability. Yet in the primary market there is no evidence to substantiate these concerns. The average prices of newly completed apartments declined sharply after a run-up in 1999, and their growth remained negative during 2000 and 2001 (Figure 2). In 2003, prices increased only in Zagreb (by about 10%), while in the first half of 2004, prices of newly completed apartments declined in all locations.

Figure 2 Average prices of completed apartments (HRK/m², annual percentage change)



Source: Central Bureau of Statistics

Data on sales of existing homes and land for construction provide more support for the spillover hypothesis. Between March and November 2004, house prices on the Adriatic increased at an annual rate of 10%, and prices of land for construction at an annual rate of 30% (Table 3). At the same time, house prices in Zagreb increased much more rapidly, while apartment prices on the Adriatic actually fell, indicating that property prices are also under strong influence of factors other than non-resident demand for vacation properties. Nevertheless, rising prices of houses and land for construction on the Adriatic reflect at least in part expectations about the future demand of foreign buyers. This is also confirmed by anecdotal evidence.^{xxvi} More importantly, rising prices of land for construction can be interpreted as a leading indicator of future increases in house prices on the Adriatic.

Given the lack of comprehensive statistical data on property sales in the secondary market, the above results need to be interpreted with caution. Data used to construct Table 3 come from a commercial source, which publishes data at weekly frequency and with a relatively detailed breakdown. However, these data do not cover all properties offered for sale, and only indicate prices that are being asked by sellers rather than actual transactions prices. Because real estate sales are subject to the value-added tax or the property sales tax, Croatian tax authorities reportedly maintain a large data base on transactions in the secondary market.^{xxvii} However, these data are not published, nor have they been made available to researchers.

Table 3 Real estate prices, November 2004¹

		Houses	Apartments	Land for construction
EUR/m ²	Croatia	1,100	1,466	43
	Zagreb	1,438	1,516	128
	Adriatic	1,096	1,402	32
Growth rate ² (annual percentage change)	Croatia	10.5	4.5	26.5
	Zagreb	22.5	11.1	18.7
	Adriatic	10.4	-3.3	30.3

¹ Average prices based on 1,267 properties offered for sale on 4 November 2004.

² Estimated from linear regressions ($\ln \text{price} = \text{const} + b \cdot \ln \text{time} + e$) of weekly data from 10 March 2004 to 4 November 2004.

Source: Jutarnji list, weekly supplements Real estate (based on www.burza-nekretnina.com); author's calculations

The Croatian Bureau of Statistics only publishes data on average prices of newly completed apartments, on a quarterly basis and with

considerable delay (these data were used in Figure 2). The news media, on the other hand, suffer from sample bias: they tend to focus on properties in exceptional locations, often bought by domestic and international celebrities. The prices of such properties do not characterise general trends in the housing market, but they nevertheless affect market sentiment and sellers' expectations, which is reflected in figures reported in Table 3 and has also been reported by market participants. For instance, many real estate agents consider prices of properties offered for sale to be overvalued by about 30% on average.^{xxviii}

Looking ahead, will the current conditions of relatively tight housing supply and rising prices of at least some houses and land for construction ease or become more pronounced with the opening-up of the market to non-residents? And what role will the speed of liberalisation play in this process?

Arguments supporting the view that pressures on the local property market might intensify fall into three categories. First, the number of properties sold to foreigners has been small to date. As noted above, since 1996 only about 3,200 property sales to foreigners have been approved. Even if the true number of realised sales is twice as high (due to provisions that allow foreigners to buy property via registered companies), this would represent less than 2% of the stock of permanent housing on the Adriatic (5% of the stock of summer vacation homes). Such a small market segment clearly cannot influence the overall real estate market. In the future, however, foreign demand for secondary residences is likely to be much higher, and might therefore have a more significant impact on developments in the housing market. As of September 2004, real estate brokers estimated the number of potential sales already in the pipeline at about 10,000 houses.^{xxix} This is equivalent to 75% of the average annual supply of new housing in the entire country. A demand shock of this size would clearly have a big impact on the local housing market, even if the sales were realised over a period of 2-3 years.

The second concern relates to construction costs. If the construction industry is operating at full capacity, increased demand for vacation homes by non-residents will put pressure on housing construction costs in the short run, which will spill over to the market for permanent housing. To the extent that the construction industry is not competitive, the increase in costs – and hence the spillover on the local housing market – will be so much the higher. One should note that in the long run housing supply is elastic with respect to both income and price, so

capacity in the construction industry is not likely to be a factor constraining the supply of housing. But cost spillovers may be present in the short run and affect expectations of future prices, in particular if there is a sudden increase in demand.

The third concern is that for an average family the affordability of housing is already low, so that any spillover of price increases and construction costs due to the opening-up of the property market to foreigners might make housing even less affordable for the local population. However, concerns about affordability relate primarily to access to housing finance and public housing policy, and have little to do with non-residents' demand for vacation properties (see Box 2).

The main argument supporting the view that demand from non-residents will not affect future supply and price of local housing is that legal uncertainties relating to property transactions will be gradually removed as Croatia approaches membership in the EU and starts implementing the *acquis communautaire*. As noted above, many properties desired by foreign as well as domestic buyers do not have clean titles, so many potential trades have not been realised. In such circumstances it is not surprising that properties with clean title fetch higher prices. More importantly, legal uncertainty is presently constraining the potential supply of permanent housing in the secondary market. Clean property titles and orderly and more efficient cadastres will most likely bring many houses, apartments and pieces of land that are currently withheld from it onto the market, including some of the 200,000 temporarily unoccupied dwellings mentioned above.

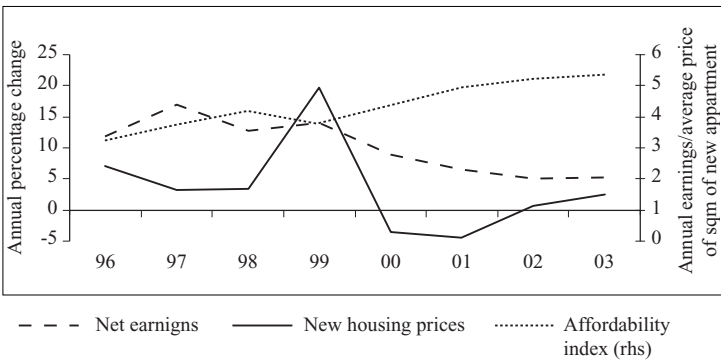
The speed with which the property market is opened up to non-residents can tip the balance of these forces in an important way. Keeping restrictions on foreign ownership in place might sustain relatively high prices by limiting the supply of vacation properties to non-residents. However, the prices of such properties and real estate in general are bound to increase anyway with rising incomes in the long run.^{xxx} The issue is then, how fast will prices of vacation properties converge to their long-term equilibrium? Given the apparent interest of foreigners in the Croatian property market, it is likely that a rapid removal of restrictions would lead to a large increase in demand for secondary residences, while at the same time the supply response would be less elastic due to legal constraints and limited capacity in construction industry. This would, *ceteris paribus*, imply faster convergence to long-run equilibrium prices, but with potentially significant spillovers onto the local housing market along the way. On the other hand, a more

gradual removal of restrictions would allow more time for the supply to respond to foreign demand, thereby limiting price increases in the short run and lowering costs of adjustment to the long-run equilibrium.

Box 2 Affordability of housing, housing finance and public housing

Contrary to widespread beliefs, the affordability of housing has not declined in recent years. Except in 1999, net earnings were growing faster than average prices of new housing (Figure 3). However, the index of housing affordability is very low in Croatia: an average annual income in 2003 was equivalent to the average price of just 5.5 m² of a newly completed apartment. In other words, one family member would need to put aside his or her entire annual income for ten years in order to save enough for a modest 55m² apartment, assuming that average income and apartment prices grow at the same rate. Affordability of housing is therefore a legitimate concern. However, one should not jump to the conclusion that housing would become more affordable if foreign ownership of real estate was more restricted. Housing affordability depends on many factors that have no connection to demand for vacation homes by non-residents. Two factors that are examined here are housing finance and public housing policy.

Figure 3 House affordability



Source: Central Bureau of Statistics; author's calculations

At present, the largest providers of housing finance in Croatia are commercial banks. Housing loans account on average

for one-third of commercial bank loans to households, which is low compared with mature market economies and some new member states.^{xxxii} Moreover, housing loans in Croatia are still relatively expensive: they are mostly short-term products with a maturity of less than ten years (although longer-term loans are now being provided by some banks); the loan-to-value ratio is typically lower than the standard in advanced market economies; interest rates remain generally high both in nominal and real terms (although they have declined in recent years); loans provided with a fixed interest rate are still rare; and most loans are provided with a foreign exchange clause so that households bear the currency risk. Banks justified these practices in the past by the difficulty of enforcing foreclosure of residential properties. However, reforms in legislation and the judiciary over the past few years have made it easier for creditors to seize properties or attach salaries used as collateral for housing loans.^{xxxiii} The fact that the restrictive practices in granting housing loans survive indicates that the housing loan market in Croatia is still relatively underdeveloped, and access to housing finance difficult for an average family.

The relatively high indebtedness of Croatian households represents a further constraint on housing affordability. In 2003 net earnings of Croatian households amounted to about 65 billion kuna, while outstanding bank loans to households amounted to 55 billion kuna.^{xxxiii} This corresponds to a debt to income ratio of about 84%, which is higher than in the euro area (about 80%). On this basis, there would not seem to be much room for expanding household indebtedness, although there is considerable room for changing the structure of household debt toward more housing loans and fewer consumer loans.

What are the other options for improving housing affordability? Contractual savings and subsidised housing schemes are still relatively unimportant in Croatia. In the six years since the first housing savings banks were established, they made only 9,350 housing loans to a total value of 60 million euros, compared with accumulated deposits of around 470 million euros in mid-2004.^{xxxiv} Judging from the experience of the new EU member states, the success of such housing schemes can be attributed largely to state-provided incentives. This, however, creates a considerable fiscal burden for the state. In 2003, the government of Hungary was forced to remove most fiscal incentives for housing, as their cost significantly contributed to the general government deficit of 9.3% of GDP in the previous year.

Given the pressing need for fiscal consolidation in Croatia, expanding subsidies to contractual housing schemes does not seem feasible.

Another approach to addressing housing affordability is via public housing policy. Even in countries with highly sophisticated financial systems some segments of the population (including the poor, people who are unable to work, and young couples) do not have access to housing finance. In Croatia there have been only two larger public housing schemes in recent years: one targeting handicapped veterans of the Homeland War; and the so-called POS scheme of public subsidies for housing construction. Under the former scheme, a total of 4,400 apartments have been constructed since 1997, with plans for a further 700 units. Under the latter scheme, 1,500 apartments have been constructed since 2000 and 8,000 more are being planned.^{xxxv} The POS scheme has been criticised, however, for poor targeting (see Tica, 2002). In particular, many poorer households are not in a position to qualify for the scheme due to relatively high down payments (over 100% of average annual income for an apartment of 50m²) and debt servicing costs (about 30% of average income).^{xxxvi} Taxpayers' money may thus have been used to assist the relatively better-off households, rather than the economically disadvantaged ones, to acquire low-cost housing.

A broader implication of this situation, rarely articulated in public discussions, is that the current younger generation finds it much more difficult to acquire own housing than the older generations. Under the socialist system, housing was for the most part provided by the public sector or labour-managed enterprises. Even after this practice was abandoned in the 1980s and families had to turn to the banks for housing loans, conditions for obtaining loans were comparatively benign. The state-owned banks extended housing loans with very long maturities, no required collateral or relatively small down payments, and at very favourable fixed interest rates, which significantly reduced the burden of debt service in an environment of high inflation.^{xxxvii} This system was, of course, unsustainable especially once the government stopped bailing out the state-owned commercial banks. Since then, with the exception of public sector housing schemes mentioned above, housing loans have been provided at essentially market terms.^{xxxviii}

In summary, there is some evidence that increased demand for secondary homes by non-residents may have already led to an increase in house and land prices on the Adriatic. The future effect will depend

on the speed with which the property market is opened up; capacity constraints and competition in the construction industry; the speed with which legal impediments to property sales are removed; and developments in household incomes, housing finance and other factors influencing the affordability of housing. In general, however, given the supply rigidities, one could expect that a measured approach to the opening of the real estate market to non-residents would allow for a more orderly adjustment than a rapid removal of restrictions.

IMPACT OF EUROPEAN UNION ACCESSION ON CROATIA'S TOURISM INDUSTRY

The preceding sections identified the right of EU nationals to acquire property in Croatia as an important issue in forthcoming accession negotiations, and discussed potential implications of foreign investment in real estate for the local housing market. This section considers how developments on this front might influence Croatia's tourism industry.

As with the real estate market, the lack of rigorous economic analysis and adequate statistical data on tourism make it difficult to assess even the size and economic potential of this industry, let alone its dynamics in the context of Croatia's accession to the EU. One of the few analytical studies available is a report by the World Travel and Tourism Council (2004), which uses the methodology of tourism satellite accounts (TSA), developed by the OECD and the World Tourism Organization in the 1990s.^{xxxix} This methodology aims at identifying more precisely different industries supplying the tourism output, and thus offers policy makers better insights into economic and other effects of tourism (see Annex).

The TSA methodology clearly indicates that travel and tourism is a key economic activity in Croatia: its contribution to GDP in 2003 is estimated at 28% (\$8 billion), and to total employment at 21% (294,000 jobs) (Table 4).^{xl} The bulk of this contribution (\$4.6 billion, equivalent to 16% of GDP) comes from spending by international visitors on goods and services (so-called visitor exports). In terms of national accounts, travel and tourism contribute 44% of total exports, absorb 19% of total imports; and account for 11% of personal consumption and 11% of capital investment.

In international comparison, Croatia ranks 22nd among more than 160 countries in terms of the share of travel and tourism in GDP

(well ahead of Austria, Greece, Italy, Switzerland and new member states from central Europe); 16th in terms of the share of travel and tourism in total employment (behind Turkey, but well ahead of the countries mentioned above); and 13th in terms of the share of travel and tourism exports in total exports. However, in terms of government expenditure on tourism, Croatia lags far behind: national and local government agencies in Austria, the Czech Republic, Greece, Hungary, Italy and Switzerland spend between 3,5% and 7,5% of their total expenditure on tourism-related services, compared with just 1% in Croatia. This seems far too low, because local government initiatives (for instance, promotion of agro-tourism in Istria) can broaden the spectrum of services offered, increase tourist expenditure and perhaps extend the tourist season. The report sees strong growth prospects for Croatia's travel and tourism industry, which is projected to expand by nearly 7% per annum over the next ten years, much faster than either EU or world-wide demand for tourism.

Table 4 Tourism Satellite Account for Croatia, 2003

	In billions of USD	In percent of GDP
Travel and tourism consumption	6.7	23.3
Personal	1.6	5.7
Business	0.5	1.8
Corporate	0.3	1.1
Government	0.8	0.6
Government expenditure – travel and tourism services	0.0	0.0
Spending by visitors (visitor exports)	4.6	15.9
Travel and tourism demand	1.2	4.2
Government expenditure – collective services	0.1	0.2
Capital investment	0.6	2.2
Other (non-visitor exports)	0.5	1.8
Total	7.9	27.5
Employment	In thousands of employed	Percent of total employment
Directly in travel and tourism	139	10
Economy-wide	155	11
Total	294	21

Sources: World Travel and Tourism Council (2004); author's calculations

The question that arises against this background is to what extent the expected increase in investment in Croatian real estate by residents of the EU might change the outlook for and the character of travel and tourism industry over the medium term. One issue that seems particularly relevant in this context is whether accession to the EU offers the opportunity for tourism to assume a leading role in overall economic development, or represents the threat to what is widely considered to be the last remaining environmentally unspoiled area of the Mediterranean within easy reach of major European cities. To address these issues, it is necessary first to consider the main features of tourism in Croatia. As it turns out, Croatian tourism is in many respects very similar to tourism in other southern European countries, so useful lessons can be learned by referring to the experience of these countries.

The first point to note is that tourism in Croatia, as in other southern European countries, is dominated by international mass tourism. The main object of mass tourism is the beach holiday, with its natural (coastal environment, climate) and man-made ingredients (restaurants, hotels, etc) marketed as “sunshine and sea” packages providing an escape from the routines of domestic and work life. This social image of tourism and the lack of product differentiation imply a high degree of substitutability among different Mediterranean resorts. They offer similar experiences – the sunshine and sea are interchangeable – and virtually the only point of competition is price.^{xli} Efforts to develop “elite” tourism focusing on high-income visitors or “sustainable” tourism aimed at keeping tourism resources available for future generations are not likely to succeed in replacing incomes generated by the mass tourism industry, which brings 8-9 million tourists to Croatia or 50 million tourists to Spain each year.^{xlii} The Common Agricultural Policy of the EU, with its emphasis on farmers as keepers of the environment and on diversification of tourist destinations, has provided a boost to rural tourism in the EU, but while important in rural areas, the net effect on the tourist industry has been minimal (Williams, 2001).

The second characteristic of mass tourism is its extreme vulnerability to developments over which the industry itself has little control. One example is tourism’s high elasticity in relation to incomes.^{xliii} Given that tourist activity does not, in the main, meet a vital need, tourist behaviour is highly volatile and subject to psychological and social influences, personal sensitivities, fashion, and short term reactions. If the image of just one link in the chain is affected, then the whole tourism industry suffers consequences. The most obvious manifestation of this sensitivity is the impact of political uncertainty or the

security situation of tourist arrivals in a given country or region. Croatia's experience during the 1990s is a clear case in point. However, the issue is present worldwide, especially since the terrorist attacks of 11 September 2001.^{xliv}

The tourism practiced in Croatia and other southern European countries is also characterised by a potentially high level of systemic risk on the supply side. Threshold levels of capital and skills required for starting a tourism business – for instance, the letting of rooms – are relatively low. This means that there is a high elasticity of supply. While this has provided an important opportunity for social and economic mobility for lower income households, most of which used to be engaged in agriculture, the ease of entry into the tourism market may threaten the longer-term competitiveness of established tourist areas as new resorts develop. Moreover, it may threaten the competitiveness of existing resorts through overdevelopment and devastation of the landscape. This problem has been particularly pronounced in Croatia, where weaknesses of spatial planning and local administration, misplaced government incentives, and failure to control clandestine (“wild”) construction have forced the authorities to take drastic measures to prevent overbuilding and protect the public coastal domain (see Box 3).

Box 3 Clandestine construction and protection of the public coastal domain

Clandestine construction has been a longstanding issue in southern European countries (see Mullins, 1991) and has recently become a major issue in Croatia. The phenomenon has diverse origins but a common outcome – devastation of the coastal environment, which is a key ingredient of the main tourism product of these countries, and hence a serious threat to their competitiveness.

The proximate causes of clandestine construction are deficiencies of spatial planning and local administration, and the failure of the authorities to enforce building regulations.^{xlv} But the ultimate cause is more likely to be the lack of clearly defined property rights. This problem was highlighted by de Soto (2000) in his seminal study on establishing capitalism in developing countries. To illustrate the problem, de Soto tried to open a small garment factory in Peru. He discovered that to obtain a license to operate such a small business took 289 days and cost 31 times the average yearly minimum wage.^{xlvi} Not surprisingly, most people bypassed the process, operating without a license. De Soto concluded that developing and

former socialist countries' principal problem in fostering private sector development was how to provide easy access to legal mechanisms such as property titles for land, houses and other assets that indigenous entrepreneurs own *de facto* but not *de jure*. Without property titles, people have no transferable rights of ownership with which to establish and operate their businesses.

In the case of Croatia, these problems have manifested themselves in long delays in obtaining clean property titles and building permits. For instance, Croatian courts have accumulated some 400,000 unresolved cases of property claims.^{xlvii} There have also been many clear violations of regulations on spatial planning and construction, which captured domestic news headlines and prompted the authorities to take determined measures, including the demolition of illegally constructed dwellings.^{xlviii} But misplaced incentives are also partly to blame. Until recently, the government subsidised loans for start-up businesses in tourism with the aim for promoting self-employment. However, most loans were used for construction of tourist apartments, often without building permits.^{xlix}

To prevent further infringement of the coastline, the government passed in September 2004 *Regulation on the protection of the coastal public domain* (Government of Croatia, 2004). This regulation is similar to Spain's *Ley de las Costas*, passed in 1988 in response to environmental backlash against the overdevelopment of the coastlines, including by foreigners who acquired a large number of secondary residences.¹ The regulation protects all islands, the sea within 300 meters of the coastline, and coastal areas within 1 kilometre. It prohibits the construction of new houses and tourist apartments within 70 meters of the coastline. Except for infrastructure facilities, new construction within 100 meters of the coastline will be allowed only in the case of hotels and restaurants in specially designated areas. The regulation also restricts other construction in settlements where the majority of the population is local as well as in tourist resorts.

While this regulation may help solve some of the most acute problems of construction in coastal areas, Croatia will continue to face problems of the protection of the public coastal domain on a permanent basis, given that tourism results in extreme pressures on the local economy and environment at a few points in time and space. In particular, 95% of hotel and restaurant accommodation capacity in Croatia is located on the Adriatic Coast and islands, and over 60% of overnight stays are recorded in July and August.

A further notable development has been a pronounced tendency towards self-provisioning. It has been most visible in the accommodation sector and has started with the growth of second home ownership of local residents. The growth of “weekend homes” in Croatia and other southern European countries is also a broader economic and social phenomenon. In the former Yugoslavia it was partly a consequence of scarcity of other goods and services on the market on which to spend income on the one hand, and the basically free provision of services such as housing, education and health care on the other. At the same time, the widespread distribution of second homes across social classes and geographical locations reflects the persistence of rural-urban ties, with first generation urban dwellers inheriting homes in the countryside. Moreover, owning a weekend home in a coastal resort is a widely held aspiration and status symbol in all social classes, a part of the mythology of what constitutes social progress (Williams, 2001).

With enlargement of the EU to Portugal and Spain and the removal of restrictions on the movement of capital in the Union in the 1990s, there has also been a marked increase in second home ownership of foreign residents. For instance, in Spain there are an estimated 2 million second homes, one million of which are owned by foreigners (ibid., 2001). However, if the experience of other southern European countries can be a guide, one should not expect a significant increase in direct foreign ownership of tourist facilities other than second homes.^{li} The reason is that foreign companies are mainly interested in facilities they can differentiate through branding and location, such as hotels aimed at business travellers or exclusive resorts. On the other hand, the tourism product being sold by Croatia (sun, sea, etc.) is largely indifferent to branding and location, so the emphasis is almost entirely on the value for money of the total holiday package. This situation is not likely to change with the growth of foreign ownership of vacation homes.

What are the major potential costs and benefits of increased foreign ownership of summer vacation homes for Croatian tourism? As noted above, the main potential cost is that of overdevelopment. Since this can result in the devastation of the coastal environment, which is one of the key attractions for tourists visiting Croatia, it would result in a loss of competitiveness for the tourism industry. One should also emphasise that there are many tourist attractions other than real estate on the Adriatic (see Kušen, 2002) that are not adequately protected and will need to be considered in the context of the opening-up of the real estate market to non-residents. The recent strengthening of building

regulations in coastal areas and the reasoned expectation that EU residents will respect these and other regulations (unlike many domestic developers in the past), provide some assurance that Croatia, unlike many coastal areas of Spain for instance, will avoid the overbuilding scenario. However, the authorities, in particular at the local level, should avoid complacency on this crucial issue, as weaknesses in the enforcement of building regulations have a long history in Croatia. The speed with which the real estate market is opened up to foreigners could make a difference here as well – a sudden increase in demand for vacation homes could increase incentives for local governments and developers to bypass the recently introduced building regulations and cash in on the interest of foreign buyers as quickly as possible.

Other potential costs for tourism are few and largely unrelated to foreign ownership of vacation homes. Croatia's tourism will in all likelihood continue to face the same challenges that it grapples with today: how to encourage greater market and product diversification; invest more in effective marketing and promotion; develop the human capital and technologies required for growth; create a more stable and predictable regulatory environment; match public and private infrastructure to customer demand; and promote responsibility in natural, social and cultural environments. It is unlikely that widespread foreign ownership of secondary residences will add to this long list of problems, the solutions for which are by and large well known but are difficult to implement because of the lack of co-ordination among different public and private sector bodies and weaknesses in local administration.

On the other hand, increased foreign ownership of secondary residences could have a number of potentially significant benefits for tourism and local communities. With the revival of interest by foreign buyers, houses and land that until recently had little or no economic value have practically overnight become a potentially important source of wealth for indigenous owners and local communities. In addition, much of the existing housing stock could be renewed by foreigners interested in owning old stone houses built in the authentic architectural style of this part of the Mediterranean. This would increase attractiveness of the Adriatic Coast and islands for other tourists as well.

Foreign investment in real estate could also revive local communities on the Adriatic. Demographic trends in many coastal communities and on most islands have been unfavourable ever since the late 19th century, and these trends seem to have accelerated over the past decade (see Wertheimer-Baletić, 2003). This has resulted in lack of investment

in housing, infrastructure and public services, with possibly tens of thousands of old houses falling into disrepair and many villages being abandoned. A trend observed in other southern European countries is that many second homes eventually become the principal homes of expatriate settlers, thereby generating year-round income streams and permanent jobs in local communities. These jobs might in turn lead to the establishment of many new households on the Adriatic, which could over time perhaps reverse negative demographic trends. The clearest examples of this course of development worldwide are the US states of Arizona and Florida, where many previously dormant communities have been transformed into vibrant centres of development after erstwhile tourists from northern states established their permanent residence in the south.

Local authorities and indigenous entrepreneurs would thus be well advised to use the current period of strong interest in Croatia as a tourist destination to plan for the future. Sooner or later, the demand and the supply are likely to shift – tourism, like any industry, cannot avoid changes in consumer preferences and the product life cycle. Or to put it differently, tourism is neither “a passport to development” nor a “unique devil” (de Kadt, 1979); its role in economic development depends on the form of tourism and on the structure of the national and regional economies within which it is inserted.

MACROECONOMIC EFFECTS

What are the likely effects of increased foreign investment in secondary residences on the national economy?

One important macroeconomic effect – the wealth effect – has already been in evidence for some time. As noted above, the value of real estate and land in areas that are attracting potential buyers has increased even ahead of any large-scale property sales to foreigners. This clearly demonstrates the powerful impact that economic expectations exert on current asset valuations. It also implies that any tightening of restrictions on property sales to foreigners would result in wealth losses. In an extreme case, prohibiting the sales of real estate to foreigners would wipe out billions of euros of potential wealth of Croatian citizens and a proportionate amount of tax revenues.

Another key macroeconomic effect relates to the potentially large capital inflows associated with non-residents’ payments for prop-

erties purchased in Croatia. Considering only the estimate of house purchases that are currently being arranged – the sales of 10,000 houses mentioned above – and assuming a very conservative average price of 50,000 euros per house, capital inflows already in the pipeline would amount to about 500 million euros, or nearly 2% of GDP. To put this number in perspective, it is equivalent to the average annual net issuance of international bonds by the Croatian government during 1995-2003, or to 50% of the average annual inflows of foreign direct investment. An overly rapid liberalisation of the real estate market could thus unleash potentially significant appreciation pressures on the kuna, which could have important effects on the external competitiveness of the economy as a whole and export industries, including tourism.

The wealth effect and the associated capital inflows will be initially distributed among property and land owners on the one side, and the construction and real estate development industries on the other. Depending on how the income thus generated is spent and invested, one can envisage a number of different macroeconomic scenarios. One possibility is that property and land owners will use the bulk of the proceeds of real estate sales to finance personal consumption, while the construction and real estate development industries will use additional revenue largely to raise wages and dividend payments. This would result in rapid growth of personal consumption and imports, inflationary pressures, deterioration of the external current account, and eventually loss of competitiveness. Another possibility is that the capital generated by the real estate sales is reinvested in local housing, tourism enterprises, or other sectors of the economy. This would lead to demand pressures and additional imports as well, but in contrast to the former scenario the productive capacity of the economy would increase, helping to maintain longer-term competitiveness. Finally, the proceeds of property sales could be reinvested abroad, so the net effect of the inflow could be more or less offset by capital outflows.

There would in addition be a series of second round effects stemming from the consumption and investment patterns of foreign owners of secondary residences. If the residences are rented out to foreign holiday makers who would otherwise purchase accommodation from domestic owners of hotels or apartments, the income stream from tourism might be reduced. However, if secondary residences become the principal homes of foreign buyers, as has been suggested above, they may generate permanent income streams for local communities and the domestic economy.

The effects of property sales to foreigners on fiscal revenues are likely to be positive. The sales as well as any increase in personal consumption resulting from the sales will generate additional VAT revenue. Likewise, additional personal and corporate incomes generated by investing the proceeds of sales will at least partly be subject to income taxes. The overall fiscal effect will then depend on how additional revenue is spent by the local communities and the central government. Here one could consider the same scenarios as with personal consumption and investment: if additional fiscal revenues are spent on current public consumption, domestic demand pressures (and possibly imports) will increase; if they are invested in education, debt repayment, infrastructure, improvements in the functioning of public services and institutions etc, demand pressures may increase, but the competitive position of the economy will improve in the long run.

All of these effects have yet to be researched, so at present it is not possible to assess with any degree of certainty the likely macroeconomic effects of foreign investment in Croatia's property. Nevertheless, given the size of potential wealth effects and capital inflows, there are solid economic arguments in favour of a gradual rather than a swift liberalisation of the property market.

CONCLUSION AND POLICY RECOMMENDATIONS

The main conclusion from the preceding analysis is that Croatia stands to benefit in the long term from foreign investment in the property sector, but in the medium term a measured approach to the opening-up of the market can be justified on a number of grounds. These include spillovers of price increases from the market for secondary residences onto the local housing market (of which there is already some evidence); costs of adjustment in the housing market and construction industry to a sudden large increase in demand for secondary residences; loss of competitiveness in the tourism industry in the case of violations of building regulations and the resulting overdevelopment of coastal areas (the incentives for which would increase if the property market is opened up suddenly); and macroeconomic pressures arising from large and sudden capital inflows.

Another general conclusion is that much additional research needs to be done on the economics of the real estate market, tourism

and on the macroeconomic effects of developments in the property market. In particular, major efforts at improving statistical information on the real estate market and tourism are necessary. For instance, without comprehensive information on transactions in the market for existing homes or in the housing construction industry, it is not possible to assess the overall state of the housing market, nor can one develop useful scenarios for the diverse macroeconomic effects of foreign investment in the property sector. In addition, the analysis has identified a number of weaknesses in the current legislative framework, from regulations on property sales to foreigners, to inadequate legislation protecting against property speculation, to the well-known problems with property titles, cadastres, and enforcement of building and spatial planning regulations.

Against this background, what approach could Croatia follow in negotiations on the free movement of capital with the EU? The difficulty of negotiations on this point can be better understood when put in the proper perspective of the way that negotiations are conducted. By joining the EU, a country accepts to adopt and apply the rules of the club. Exceptionally, the EU agrees that certain rules can be adopted over a longer time horizon after membership, provided that exceptions are limited in scope and in time. Exceptions are therefore temporary in nature and granted to allow a country sufficient time to adapt. In the case of Croatia, a transitional period for investment in real estate lasting four years from the entry into force of the SAA has already been agreed. However, Croatian authorities could decide to extend this period once negotiations on EU membership begin. But since other requests for transitional periods will undoubtedly be made in the negotiation process, the authorities will need to set up priorities among different areas, deciding whether, for instance, it is more important to request a longer transitional period for the real estate sector or for adjustment in agriculture.

Yet, if transitional periods are exceptional, it is evident that permanent arrangements – also known as derogations – are practically ruled out. The reason is that by their very nature derogations go against the principle that the law is equal for all (Busuttill, 2002). Derogations also go against the spirit of acting in common, because they allow a country to operate outside the scope of the law binding all the rest. If derogations applied in all cases, there would be no common action and there would be little scope for having the EU at all. No country can expect to benefit from the rights of membership if, at the same time, it does not want to shoulder the obligations.

Although Section 2 highlighted some examples in EU law where derogations have been granted to individual countries to allow them to operate differently from the rest – for instance, the cases of Malta and Denmark in respect of restrictions on foreign ownership of secondary residences, and Poland in respect of agricultural land purchases by non-residents – it is not likely that Croatia will be able to wring any meaningful concessions out of the EU. The reason is that it would be very hard to prove that Croatia has a paramount reason for not allowing EU residents to buy property beyond one secondary residence. Inadequate legislation against property speculation is a weak excuse – adopting such legislation is in the interests of the country already, as domestic residents could engage in such activities. Likewise, it is not in the long-run economic interest of Croatian citizens and the authorities to further restrict foreign ownership of real estate, as this would wipe out considerable amounts of potential wealth and fiscal revenue. A well articulated public discussion could nevertheless help in formulating arguments to support Croatia's case on this and other important issues, and in deciding on the priority areas that need adjustment and hence longer transitional periods.

Turning to the real estate market, Section 3 identified two channels through which the opening of Croatia's real estate market to EU residents could affect housing prices and affordability: expectations of future price increases, and housing supply rigidities in the event a rapid liberalisation leads to a sudden increase in demand for property by foreign investors. Recommendations in this area are therefore more straightforward. First, the authorities need to stabilise the expectations that a housing boom on the Adriatic is imminent. Particularly helpful in this respect would be a more transparent and efficient application of existing regulations on sales of real estate to foreigners, and the continued determined implementation of the latest regulation on housing construction and protection of the coastal public domain.

Second, much can be done to improve the legislative framework and administrative procedures for property transactions. Legal uncertainty is probably a major constraint on the potential supply of permanent housing in the secondary market at present. Clean property titles and orderly and more efficient cadastres would bring to the market many houses, apartments and pieces of land that are currently withheld from the market.

Third, one aspect of housing finance that is visible in most industrial countries and many new EU members but is absent in Croatia

is involvement of the state in the mortgage market. Hungary and Poland, for instance, introduced legislation on mortgage bonds and mortgage banks following the German approach, while in Bulgaria, the Czech Republic, Latvia, and Slovakia commercial banks can obtain a mortgage banking license and issue mortgage bonds, which provide banks with an alternative tool to raise funds earmarked for housing loans. In addition, in most European countries the state has been providing a limited amount of housing loans directly, by establishing public funds to promote housing construction and finance. While Croatia has developed two such schemes, it is not clear that one of them (the POS scheme) is well targeted.

In Section 4 it was argued that the character of Croatia's tourism is not likely to change significantly with the growth of foreign ownership of vacation homes. While some additional pressures on the environment and local economies can be expected, they would not differ qualitatively from the pressures that tourist resorts are already experiencing with the robust growth of tourism in recent years. As for the broader implications of EU accession on Croatia's tourism industry, these can be largely separated from the issue of increased foreign ownership of vacation homes. Thus far there has been little EU intervention in the field of tourism. Freedom of movement provisions, competition law and other EU regulations have barely touched the tourism industry (Williams, 2001). Most tourism regions in Croatia will have to face choices about diversifying their source and product markets, imposing stricter development controls and improving the quality of their tourism product irrespective of accession to the EU. Given the ease of entry into tourism, which is dominated by fragmented indigenous capital, they will also face greater competition from other southern European destinations and the challenge of constantly adapting to new forms of demand. Some resorts may decline as a result unless they are reinvigorated by new investment and innovation. In this area, foreign investment in real estate could play a very useful role.

Regarding the macroeconomic effects of foreign investment in the property sector, no one knows exactly how many foreigners may eventually end up buying property in Croatia. Perhaps the share of secondary residences owned by foreigners will never be as high as for instance the 50% share in Spain. In the case of Croatia, this would imply purchases of some 100,000 vacation homes by foreigners, resulting in potential inflows of 5 billion euros, or 20% of GDP. But as argued in Section 5, even if foreigners purchase only a few thousand vacation homes, the

effects on the local and national economies would be sufficiently high to warrant caution on the part of macroeconomic policy makers.

Annex

Measuring the economic impact of tourism: Tourism Satellite Account

Tourism plays a significant role in many economies in terms of the production of goods and services and the creation of employment opportunities. However, tourism remains difficult to define and measure, and as a result the industry suffers from a credibility problem. In the case of conventional industries such as agriculture or manufacturing, the contribution of industry to GDP is measured from the supply side, i.e., from the value of goods and services they produce. In the case of tourism, this conventional approach covers mainly the output provided by the hotel and restaurant industry, which is equivalent to only about 3% of GDP in Croatia. Yet the contribution of tourism to GDP goes far beyond this narrow definition, to other industries supplying tourism output such as agriculture, fishing, the food industry, construction, transportation, cultural establishments, etc.

In the past, economists relied on estimates of income multipliers to approximate indirect effects of tourism on domestic industries other than hotels and restaurants.^{lii} This methodology, however, is unreliable as it is based on many ad hoc assumptions. In contrast, TSA recast the national accounts so as to identify the diverse products and services that are delivered to domestic and foreign visitors. On the demand side, TSA include two basic aggregates:

- *Travel and tourism consumption*, which includes four components: (i) the value of products and services consumed by domestic and international visitors for personal travel and tourism; (ii) business travel by government and industry; (iii) expenditure by individual government agencies and departments that specialise in visitor services (cultural and recreational establishments, immigration and customs, etc) and (iv) spending by international visitors on goods and services (so-called visitor exports).
- *Travel and tourism demand*, which estimates a broader, economy-wide impact of tourism and includes three components: (i) public

spending on tourism promotion, aviation administration, security and similar services made on behalf of the community at large but closely associated with tourism (so-called collective government expenditure); (ii) capital investments to provide facilities, equipment and infrastructure to visitors and (iii) goods and capital sent abroad for ultimate sale to visitors or use by providers of travel and tourism services (so-called non-visitor exports).

On the supply side, TSA also produce two different aggregates: the *travel and tourism industry* and the *travel and tourism economy*. The former captures only the direct impact of travel and tourism for comparison with conventional industries such as manufacturing. The latter captures the broader, indirect, or economy-wide impact of travel and tourism. The TSA show separately the portion of travel and tourism supply that is imported (including expenditure on outbound travel by domestic residents), and also calculate direct and indirect components of value added produced by travel and tourism industry. Finally, the TSA show employment for travel and tourism industry and travel and tourism economy.

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- i *The excluded sectors are agricultural and forestry land, forests and areas protected under the Environmental Protection Act (NN 30/94), including national parks, nature parks and other protected areas of nature.*
 - ii *See "Information about acquiring real property ownership in Croatia for foreign citizens" on the website of the Ministry of Foreign Affairs [www.mvp.hr].*
 - iii *The lengthy approval procedure is perhaps more a reflection of red tape in various ministries and local governments involved (on this, see World Bank, 2004) than of the strictness of regulations per se.*
 - iv *Properties acquired by residents of Slovenia before the split of the former Yugoslavia are not affected by this regulation. Many vacation homes owned by residents of other former Yugoslav republics before 1991 have been sold in the meantime. However, the status of many resort properties and much commercial real estate owned by companies from the former republics is still unresolved (see Nacional, 22 June 2004 [www.nacional.hr]).*
 - v *Similar data were earlier quoted in Slobodna Dalmacija, 26 August 2004 [www.slobodnadalmacija.hr] and Nacional, 31 August 2004. Data reported in Table 1 were released after one member of the Croatian parliament officially inquired about this issue in the parliament.*
 - vi *Different news media have reported vastly different approval rates. According to Financial Times, approval to buy property is given to 95–98% of all applicants (FT House and Home, 15–16 May 2004; www.ft.com). However, according to Slobodna Dalmacija (26 August 2004) and Novi list (13 September 2004; www.novolist.hr), approval to buy property has been given to only 36% of applicants, which is closer to the subsequently reported official figures shown in Table 1.*

- vii *See Jutarnji list, 20 March 2004 (weekly supplement Real estate, page 47).*
- viii *Property speculation is usually defined as the holding of unimproved or under-improved property for the purpose of reselling profitably without any substantial capital investment. Local authorities in Croatia currently impose a tax on unused land for construction and commercial property; however, the tax rate is fairly low (up to a maximum of 15 kuna, or 2 euros, per square meter), and unused residential property is not taxed (see Kesner-Škreb and Kuliš, 2001).*
- ix *The Croatian tax authorities define capital gains on property sales as the difference between the sale price and the purchase price of property adjusted for the producer price index of industrial products (see Law on the income tax, NN 127/2000, 150/2002 and 163/2003, paragraph 23). In other words, any increase in the value of property due to producer price inflation is not taxed.*
- x *See for instance Government of Bulgaria (2000) and Government of Romania (2001).*
- xi *Certain types of activities, in particular self-employed farmers who wish to establish themselves and reside in new member states, would be allowed to buy land immediately.*
- xii *Only Ireland and the United Kingdom have allowed free immigration of workers from new member states as of 1 May 2004.*
- xiii *See Vjesnik, 30 August 2004 [www.vjesnik.hr] and Novi list, 13 September 2004.*
- xiv *See Treaty on European Union, Protocol (No 1) on the acquisition of property in Denmark, Official Journal C 191, 29/07/1992 p. 68.*
- xv *For an insightful game-theoretical analysis of negotiating strategies used by the EU and CEEC (including Bulgaria and Romania) see Papadimitriou (2002).*
- xvi *Recent references include Bezovan (2004); Družić (2001); Fröhlich (2003); and Tica (2002; 2004).*
- xvii *About 10% of dwellings are rented and 7% are shared with other families (2001 Census).*
- xviii *In addition to owner-occupied housing, other categories in this classification include privately rented, co-operative and social housing.*
- xix *In Bulgaria, Estonia, Hungary, Slovenia and Romania the ratio of owner-occupied housing exceeds 90%.*
- xx *This comparison assumes that in equilibrium the number of households is equal to the number of permanently occupied dwellings.*
- xxi *Temporarily unoccupied dwellings include vacant dwellings for rent or sale; those that are not used or rented by their owners; and those that are being refurbished. Note that vacation homes and apartments are not included in this category.*
- xxii *Comparable data for the more recent years are not available because of change in statistical methodology.*
- xxiii *Data for the coastal area and islands are approximated from census data for 7 counties abutting the sea.*
- xxiv *See for instance International Herald Tribune, 7 June 2004 [www.iht.com]; Financial Times, 15–16 May 2004 and Daily Mirror, 8 July 2004 [www.mirror.co.uk].*
- xxv *See Vjesnik, 14–15 August 2004, pages 20–21.*
- xxvi *See for instance Večernji list, 20 September 2004 [www.vecernji-list.hr]. According to Vjesnik (14–15 August 2004) and Slobodna Dalmacija (22 September 2004), prices of land increased in many areas of the Adriatic by over 100% in two years and, depending on the location, varied from 20–500 euros per m².*
- xxvii *Newly completed properties are subject to the VAT at a rate of 22%, while sales of existing properties are subject to a 5% tax on real estate sales; see Kesner-Škreb and Kuliš (2001).*

- xxviii See *Jutarnji list*, 20 March 2004 (weekly supplement *Real estate*, pages 44–45).
- xxix See *Slobodna Dalmacija*, 22 September 2004.
- xxx In the OECD countries, average house prices have not declined in nominal terms in any year since 1945.
- xxxi Housing loans account for 67% of total loans to households in the euro area and 64% in Hungary.
- xxxii For instance, in the municipal court in Zagreb there were 1,200 cases of foreclosure involving auctions of seized properties in the past four years (*Dnevnik*, 24 May 2004; www.dnevnik.com). In the municipal court in Split, 380 such cases were being processed in early 2004 (*Slobodna Dalmacija*, 7 May 2004).
- xxxiii The figure on net earnings was obtained as the product of average net earnings in 2003 (3,918 kuna per month) and average number of persons in paid employment in legal entities during 2003 (1.39 million).
- xxxiv See *Dnevnik*, 23 September 2004.
- xxxv See the web page of the Ministry of Environmental Protection, Physical Planning and Construction [www.mzopu.hr].
- xxxvi Down payment amounts to 131 euros per m², and monthly debt servicing cost to about 160 euros for a 40,000 apartment [www.mzopu.hr]. As noted above, average monthly personal income in 2003 was about 520 euros.
- xxxvii A personal anecdote illustrates this point: when the author started his first job in 1982 and inquired about the burden of housing loans, one of his colleagues replied: “It’s really easy: the first few months your entire salary goes to repay the loan, and after a year or so the monthly payment costs the same as a bottle of wine”.
- xxxviii One should recognize at the same time that the current older generation is worse-off in terms of health care costs, which were fully subsidized during socialism but are now increasingly borne fully by the patients.
- xxxix Another useful study is the tourism development strategy elaborated by the IZTZG (2003).
- xl These figures are adjusted for the latest data on GDP and employment in 2003. The World Travel and Tourism Council (2004) used preliminary estimates of these series. On this basis, the contribution of travel and tourism in 2003 was estimated at 22.4% of GDP and 27.4% of total employment.
- xli Estimates of price elasticities of demand by tourists from western Europe and the United States for holidays in Italy, Greece, Portugal, Spain and Turkey range from –0.3 to –3.2. That is, a 1% increase in the price of a package holiday in country A will reduce the demand for vacation in that country by western European and US visitors by up to 3.2% (see Syriopoulos and Sinclair, 1993).
- xl ii It is interesting to note that social science researchers (including in Croatia) have shown considerable interest in sustainable tourism (see for instance Carić, 2003; Creaco and Querini, 2003; Petrić, 2003; and Petrin, 2004), but very little interest in analytical work on the economics of tourism.
- xl iii Average income elasticity of demand for holidays in Italy is estimated at around 2.0; in Greece and Turkey 1.8; Portugal 2.5; and in Spain 1.5. That is, a 1% decrease in income of western European visitors is associated with a 2.5% decrease in demand for holiday travel to Portugal (see Syriopoulos, 1995).
- xl iv See for instance Scottish Parliament Information Centre (2002).
- xl v For problems of spatial planning in Croatia, see Kranjčević (2005).
- xl vi For other vivid examples, see World Bank (2004).
- xl vii See *Vjesnik*, 9 July 2004.

- xlviii *In the spring of 2004, a total of 185 properties were demolished (Vjesnik, 11 September 2004). The problem is even more pronounced in Albania: in January 2003 the government said only 500 of the 3,000 buildings on the 450 km coast were legal. It has since destroyed 1,000 and recently announced it would raze further 300 illegally built hotels and restaurants (International Herald Tribune, 23 September 2004).*
- xlix *See Dnevnik, 6 June 2004.*
- l *See Government of Spain (1988) and Ministerio de medio ambiente (2004).*
- li *For instance, Spain's 65 hotel groups own some 30% of hotel capacity (the rest are mostly small family-owned hotels). But only one-quarter of hotel groups have any foreign capital, and in only half of these groups does foreign participation exceed 50% of capital (Estudios Turisticos, 1988).*
- lii *See for instance Diamond (1969) and Sinclair (1998).*

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